AUDITING

Theory and Its Application

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FIRST EDITION
FIFTH IMPRESSION

McGRAW-HILL BOOK COMPANY, INC.
NEW YORK AND LONDON
1942

AUDITING: THEORY AND ITS APPLICATION

PRINTED IN THE UNITED STATES OF AMERICA

THE MAPLE PRESS COMPANY, YORK, PA.

PREFACE

This, to our knowledge, is the first book in its field to have both a text which contains a practical coverage of the whole subject of auditing practice and procedure and a wide selection of cases drawn from actual practice.

The text material was produced for the first time in the summer of 1939 in mimeographed form. Since then it has been subjected to use in the classroom and has been criticized by several outstanding practitioners and accounting teachers and authors. Particular thanks are owed to Mr. John Fraser of S. D. Leidesdorf & Co.; Mr. P. K. Knight of Arthur Andersen & Co.; Mr. C. Oliver Wellington of Scovell, Wellington & Company; Mr. Percival Brundage of Price, Waterhouse & Co.; Mr. Homer N. Sweet of Lybrand, Ross Bros. & Montgomery; Professor Alfred D'Alessandro of Northeastern University; Mr. Maurice M. Lindsay of The Bentley School of Accounting and Finance; and Professor Theodore Lang of New York University, for many constructive comments which we have endeavored to use. The text was entirely revised during the summer of 1941 and was brought up to date by the inclusion of the latest pronouncements of such authoritative bodies as the American Institute of Accountants and the Securities and Exchange Commission.

The cases in this book really amount to a new third edition of the author's "Problems in Auditing," which was originally published in 1930, and which collection of cases has been subjected to rigorous weeding out and careful addition on the basis of the results experienced from their use in classes conducted by the author and other teachers of the subject. Of the 126 cases used in the first edition 48 were discarded and 78 were used in the second edition along with 71 others new to the collection. Of the 149 cases in the second edition, 65 (including 30 from the first edition) are still being used in this book, and 29 new cases have also been included. The policy of not discarding useful cases merely because they were gathered several years ago is still being followed. In obtaining this collection of cases the author has

had not only the assistance of the staff at the Harvard Business School, but also active cooperation from practicing public accountants and others. Once again we must particularly acknowledge our debt to the firms large and small which have generously provided us with material. A constant flow of cases over the years has enabled the collection to show developments in a rapidly changing field. These cases present problems in auditing which may be used to stimulate discussion and thereby develop and portray the principles involved, as well as to illustrate the application of these principles to specific situations in business.

This volume is the seventh book made possible by the Arthur Lowes Dickinson Fund. Miss Virginia Jenness and Miss Margaret Reilly deserve mention for able assistance rendered in preparing the manuscript for publication.

Arthur W. Hanson.

SOLDIERS FIELD,
BOSTON, MASS.,
May, 1942.

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INTRODUCTORY

CHAPTER I

PURPOSES AND SCOPE OF AUDITING

DEFINITION OF AUDITING

In the present complex state of affairs it is necessary for institutions, businesses, and individuals to keep records of their condition and progress. Whether these records are reliable is often a question. An audit is an examination of such records to establish their reliability and the reliability of statements drawn from them. Opinion as to the reliance to be placed upon the statements is usually given in a report, the short form of which is often referred to as a certificate.

THOSE WHO DO AUDITING

Auditing in the United States is done principally by independent public accountants, professional men organized to offer their services to the public. They are called accountants not only because they are equipped to perform the analytical work of auditing accounts, which is usually their most important activity, but also because they are in a position to do constructive accounting work such as preparing and interpreting statements and reports, devising and installing accounting systems, and offering advice as to accounting practice and procedure.

Of late years it has become customary for large organizations, particularly industrials, insurance companies, banks, and governmental bodies, to build their own internal auditing staffs. These may limit themselves to minor routine checking or their work may be developed to such an extent that it becomes an important part of the system of internal control. In this treatment we shall focus our attention on the public accountant, but his practice and procedure can, to a large extent, be adapted to internal auditing.

PURPOSES OF AUDITING

All of those who have to rely on accounting statements feel more secure if the statements have been passed upon by inde-

pendent technical experts. The management needs to know the condition of the enterprise and its progress, not only in general but also in its various aspects. It wants to be protected against fraud. It must have facts upon which to base plans for change and expansion. It requires protection against poor methods, errors, and carelessness. When the book records have been ascertained to be reliable, management has at its disposal facts upon which it may reasonably base decisions.

The owners rightly believe that for a fair report on their business they can rely upon periodic statements certified for them by a reputable firm of public accountants.

Certified reports may be of interest to the various classes of creditors. Banks often require certified statements as a basis for decisions involving the granting of credit. It is not unknown for a bank to suggest that certain public accountants, in whom by reason of experience it has particular confidence, be engaged to audit the records of a credit seeker as a condition precedent to the extension of credit.

If a business is to be sold or subjected to change of form or management, the certificate or report of a disinterested, competent auditor may be a great help in establishing facts and formulating decisions as to volume of sales, profitability of sales, net worth, etc.

To establish facts in cases of dispute and litigation or to ascertain the causes and extent of difficulties for creditors or owners may be important results of the auditor's work.

Sometimes, as in the case of public utilities, statements certified by public accountants are of the greatest use in determining prices to be paid by the public for services, although, unfortunately, public utility commissions usually rely for rate purposes on unaudited reports made by operating companies and on their own auditors and engineers.

More and more the public wishes to have the statements of its governmental divisions examined and reported upon by independent experts.

During the past few years the Securities and Exchange Commission and the several stock exchanges have set up requirements calling for certified statements as a basis for registration and listing.

Finally in our enumeration, which is by no means all-inclusive, the reports of public accountants may be of assistance to insurance companies called upon to settle for losses.

SERVICES PUBLIC ACCOUNTANTS RENDER

To satisfy purposes such as those suggested above, the public accountant must be prepared to perform various sorts of audits and to render several other services. Various attempts have been made to classify these services, but none has met with universal acceptance. However, the classifications below are in fairly general use.

The Detailed Audit.—Each audit should be tailor-made to fit the peculiar conditions of the particular engagement. If the auditors are concerned with a small business with one bookkeeper, who keeps the records according to a poorly devised plan in a slipshod manner, they may decide that a detailed check of every transaction is necessary before they can arrive at figures which are reasonably reliable. Such an audit would truly be a detailed audit, if they were fortunate enough to locate all the supporting evidence necessary for carrying out the job. This possibility is exceedingly doubtful. Moreover, such an audit is costly, relative to the worth of the concern. Rather than attempt it, it is sometimes better to let bygones be bygones, draw up a balance sheet as of the present as best one can, and resolve that in the future the records will be kept in better shape.

Even at best there are difficulties in auditing the small business described above. Since there is but one bookkeeper, there is no opportunity for mistakes made by him to be caught automatically by the work of another employee; there is, in other words, no internal check. Then again, if this one employee is dishonest, he has every facility for hiding the fact. In all our large cities are found small public accounting concerns, frequently of the one-man type, which cater to the needs of small businesses.

In larger businesses there is necessarily some subdivision of labor. Instead of one journal containing all the debits and credits for all the transactions, there are probably several books of original entry, each of which is kept by a separate employee or, indeed, by a group of separate employees. Instead of one ledger, there are probably a general ledger and several subsidiary ledgers, and here again, the work is assigned to specialists, each doing his own particular task and being given no time or opportunity to have access to the records kept by others. Indeed, in addition to the bookkeepers there will probably be others, such as cashiers, receiving clerks, and shipping clerks, who are not ordinarily

thought of as bookkeepers, but who, nevertheless, often keep records of one sort or another, which may serve as a check on the bookkeepers. Then again, as the business becomes larger and more complicated, it is quite possible that the bookkeeping system has been better devised than one which has been more or less naturally allowed to spring up in a small concern. When there is a well-devised system, well kept by several employees who serve as a check upon each other (a good system of internal check), more reliance can be placed upon the records as they stand in the books, and less necessity exists for checking every single transaction. Internal check can be improved by moving employees around occasionally from one job to another, and by having substitutes take on the various jobs during vacations. When the system of internal check is efficient, errors and fraud may be caught with far less effort, and more effectively, than would otherwise be the case if the auditor were to check over all the transactions in detail some time after the transactions had taken place, although, for various reasons, employees sometimes refrain from mentioning well-grounded suspicions.

These facts have led to the development of audits which are not so thoroughly detailed as to be prohibitively expensive. The aim is to provide a fair amount of protection and assurance at reasonable cost. To have absolute protection against robbery, the community would have to provide so many policemen as to make the cost unbearably high. We must, therefore, rest content to have an occasional robbery but to have the cost of protection within our means. Likewise in auditing! The perfect, foolproof audit for a typical business would take an unduly long time, so that the results obtained would be worth little and the cost would be out of all proportion to the benefits usually to be expected from such a thorough piece of work.

If the bookkeeping system is good and well kept, and the system of internal check efficient, it may be the practical thing to make various tests of the records and rely upon them. The statistical theory of sampling teaches us that a fair sample reflects general conditions reasonably well. If sufficient tests reveal nothing but accuracy, it is likewise proper to assume that the parts untested are also accurate. In this day and age, therefore, when a business has a good bookkeeping system and a good system of internal check, a test audit, which efficiently samples the transac-

tions throughout a period, is about as detailed an audit as one would expect to find. Here the attention is focused upon the transactions of the entire period under review. It must be clearly understood that, being a test audit, such an audit may not necessarily catch all instances of fraud and mistake. If the checking is done periodically throughout the period of time under review, such an audit may be called a continuous audit.

It is the responsibility of the public accountant to determine how much work must be done in order that he may express an intelligent opinion. If the client restricts the scope of the audit unduly, the accountant must be guided by the following paragraph from the American Institute of Accountants' pamphlet, "Extensions of Auditing Procedure," dated October 18, 1939:

> As previously stated, if such exceptions are sufficiently material to negative the expression of an opinion, the auditor should refrain from giving any opinion at all, although he may render an informative report in which he states that the limitations or exceptions relating to the examination are such as to make it impossible for him to express an opinion as to the fairness of the financial statements as a whole.

The Balance Sheet Audit.—As generally understood, the balance sheet audit comprehends verification of all balance sheet items as of a given date, together with sufficient review and tests of profit and loss items to permit certification of an income statement and a statement of changes in surplus for the period ending on the date of the balance sheet. As its name implies, its emphasis is on the balance sheet and, therefore, on conditions as of the date of the balance sheet. In large part the review or tests of operations for the period preceding are incidental to the verification of the items in the balance sheet. It is quite customary in such an audit, if conditions warrant, to subject a chosen month or two of the period under review to a detailed checking. In addition, a few broad tests are usually made as a general check upon the statement of income for the period. Since in recent years the tendency is to attach less importance to the balance sheet and more to the statement of profit and loss, there appears to be a growing disposition to extend the scope of these general checks upon income. If development continues in this direction, the time may soon come when the balance sheet audit as such will be a thing of the past and when we shall more properly speak of a test audit leading to a certified balance sheet and a certified statement of profit and

loss. It has been suggested that the term "general audit" should be substituted for balance sheet audit even today. However, the *Federal Reserve Bulletin* of April, 1917, "Approved Methods for the Preparation of Balance Sheet Statements: A Tentative Proposal Submitted by the Federal Reserve Board" said: " . . . under present practice probably more than 90 per cent of the statements certified by public accountants are what are called balance-sheet audits," and the balance sheet audit is still the usual type.

Cash Audit.—In the cash audit, cash transactions are verified as completely and in as much detail as is thought necessary. Such an audit may be satisfactory in cases where fraud is suspected or where it is desired to establish the accountability of one who has been entrusted with cash for some purpose to be fulfilled. In this type of audit it is customary to build a statement showing all cash flowing in and out and the balance remaining, which is generally verified as being in bank or on hand.

Investigations.—In general, investigations are important analyses to secure useful information for a specific purpose. An examination of this type may involve a detailed or test audit, or it may involve statistical computations from the unaudited records. Investigations for financing are well known; these attempt to compile from the figures of the past information which may throw some light on the future profitability of the business in question in its reorganized form. Likewise an investigation along somewhat the same lines may be helpful in connection with the purchase or sale of part or all of a business. Frequently, an investigation is made to ascertain amounts payable in connection with royalties, licenses, or contracts, or to determine useful information in matters subject to arbitration or litigation. There is no reason why an audit of some particular aspect of a business may not be made if conditions call for it. This would involve detailed study and analysis of part of the accounts and would, therefore, be a partial audit.

In work of this type, there are no set rules as to just what should be done; the professional public accountant is supposed to be an intelligent man with knowledge and experience, and it is his job to determine from the facts at hand what is worthy to be reported and how it may best be shown. In all the work of the auditor he must not allow himself to be bound rigidly by hard and fast rules. If he could learn a few simple rules, the fulfillment of

which would satisfy all needs, he might never be worth to his clients more than \$25 or \$30 a week; it is the fact that his work requires judgment and discretion, intelligence and training that justifies the large income that a successful public accountant sometimes receives.

Miscellaneous.—In addition to audits and investigations of various sorts and for various purposes, the public accountant is usually equipped to perform other services for his clients. Since taxes may be based on information which is or should be in the books and records of the business, which he may or may not have audited, it is customary in many cases for the public accountant to be asked to do part or all of the work in connection with preparation of tax returns. Some businesses have their own tax departments and require only occasional advice and assistance from outside experts. It is more usual, however, for the public accountant to compile tax information in the course of his audit and to prepare tax returns therefrom for the business. If the public accounting office has a large volume of tax business, it may have one or more tax experts whose entire time is devoted to this phase of the work.

Sometimes public accountants are asked to prepare statements from unaudited books and records. In this instance, they must make sure that readers of the material produced are not misled into relying unduly upon the auditors' connection with the work, which may consist almost completely of copying and arrangement. In the opinion of one practising public accountant, the preparation of unaudited statements by a public accountant is so liable to misconstruction that this type of work should be discouraged altogether.

Public accountants are often also called upon to devise and install systems, both of general accounting and cost accounting. In large offices specialists are to be found whose entire effort is given to these activities and to surveying and commenting constructively upon existing systems. In fact, so great are the complexities of modern business that specialization may even be found among auditors as such, some working always, for example, on bank audits, others on brokerage audits, and yet others on department-store audits.

Some public accountants have built up their reputations because of the assistance they have been able to render business

in the formulation of budgets and budget policies, either by merely offering opinions and assistance or by actually effecting the whole budget plan and putting it into operation. Budgets are estimated goals to be reached in the various aspects of the business; they are a pattern for the future drawn from a knowledge of present and past conditions, and are useful in the determination of efficiency and the causes for actual performance running before or behind expectancy.

In addition to all these more or less definite classes of service, public accountants may be asked for opinions on accounting and financial matters of all types. Following the English custom, we may expect auditors in the future to function frequently as trustees and arbitrators. Often they give testimony as experts, assist counsel in commercial disputes, and perform the work of comptroller, accountant, or bookkeeper. So broad are their services that frequently they are looked upon as business doctors, ready, able, and willing to cure all afflictions to which modern business is a prey. The wise accountant, nevertheless, adheres to opinions based on facts and does not allow himself to venture unduly into the uncertain paths of the soothsayer.

ORGANIZATION OF THE PUBLIC ACCOUNTING OFFICE

Although there are thousands of public accounting offices throughout the United States, each manned by a staff of only one or two men and serving small businesses particularly, these are not, in spite of their large number, the public accounting organizations which cater principally to the medium and larger American businesses. The firm with from a half dozen to several hundred men fills this want. In such a place the personnel is usually divided into classes. Since it is not considered good practice for professional men to incorporate, be they doctors, dentists, lawyers, or accountants, the heads of the office, if more than one, are customarily partners. If it is a branch, the head is likely to be a partner of a firm which is perhaps national or even international in scope. Sometimes such men are known as principals. Much of the work flowing into the office comes from social or business contacts they have made. They usually do little of the routine work themselves, devoting their time to supervising the initial stages of assignments, criticizing audit programs, reviewing the work of others, signing reports in the firm name, working on

troublesome problems and decisions, and having general oversight of the office. If the office is small enough, they may perform the functions of managers or supervisors.

Managers or supervisors are in charge of a group of jobs, which they superintend. Their time is devoted to visiting the various places where work is being done under their direction and following the progress of the work. They render necessary assistance to the man in charge of each assignment and aid him throughout the work, including the preparation of the report or certificate to which the firm name is to be signed.

Each engagement is in charge of a senior accountant, who decides, often with the assistance of a manager or even a principal, what should be done and who should do it, prepares analyses and statements, and writes the reports to be submitted to his superiors and to be released finally to the client.

Below the senior is the semisenior, who is in charge of smaller assignments and works under the direction of a senior on jobs which it is felt he is not as yet prepared to take under his own direction.

At the bottom of the ladder are the junior accountants, all of whose work is done under more or less minute direction and supervision of the senior in charge. Sometimes these juniors begin their public accounting experience as office assistants in the report department, comparing finished reports with original work sheets and checking arithmetical calculations.

An office manager may be in charge of keeping the work flowing smoothly through the office, assigning men to engagements, and checking up on their activities. Numerous machine operators, clerks, typists, and stenographers complete the personnel.

QUALIFICATIONS OF AN AUDITOR

Personality.—Now that we have made a general review of the work performed by a public accounting office and the way in which it is organized, we may well ask ourselves what sort of men are most likely to meet the requirements of this work. Since the work is performed for clients and, to a large extent, in their places of business and in close contact with their personnel, the first requirement for success is a pleasing personality and ability to get along well with other people even when conditions are not such as to be conducive to it. A bright, cheerful, sunny disposition,

without bubbling over into silliness and foolishness, is an invaluable asset. As a matter of fact, few positions in business allow one to work in a solitary cloister; it is well, therefore, for any young man contemplating going into it to begin early to cultivate such virtues as courtesy, tact, patience, friendliness, and agreeableness. However, the public accountant needs also to foster virtues like courage, daring, inquisitiveness, and aggressiveness in order that he may go forward and extract pertinent facts and then hold fast to his well-thought-out convictions, even though they may not be thoroughly to the liking of the client or others. He must take nothing for granted and must confirm any statements given to him to the fullest extent possible. In fact, some accountants believe that being a little suspicious is not out of place in the accountant's make-up. He must be possessed of good powers of imagination. Regardless of other qualifications, it is almost impossible for a young man to get employment in public accounting without a personality which is acceptable to the prospective employer.

General Education.—Since it is becoming more and more common for the usual businessman to have a fairly good general education, the young public accountant should be able to think, talk, and write intelligently on the usual current topics of the day, including music, sports, literature, history, science, and current events. Without this equipment he is likely to develop an inferiority complex among his fellows, which is not compatible with the strong position for which his work frequently calls.

Technical Education.—If the auditor is to give advice on matters pertaining to accounting and finance, he must, of course, have a thorough knowledge of their theory, practice, and procedure. Unless he feels that he has well above average ability in these areas, he will do well to abandon the thought of attempting to become a specialist who is capable of selling his abilities to an ever more exacting public. And a specialist in a segment of business must necessarily have a good working knowledge of economics and business and its organization to which he is to apply his specialized knowledge. Business is in such close contact with the impact of the law in contracts, sales, negotiable instruments, real and personal property, bailments, and bankruptcy that a good working knowledge of commercial law will be found to be essential. This knowledge of the law will also extend to Federal and state taxation

in various aspects, such as franchise, income, inheritance, and property taxes.

English.—Since it is necessary to communicate with clients and others, both by the spoken and the written word, and important impressions are conveyed by the way in which this is done, training in public speaking may well be part of the equipment. Successful men in all activities are called upon frequently to make public addresses. It is often the most forceful and most ethical opportunity one has of calling general attention to one's ability and may be one's most effective publicity. Appealing conversation is a handmaid of personality, whether in private or public life. It must not be forgotten that the final fruit of the public accountant's work is almost always a report. Too many accountants can do everything well except prepare an acceptable report, and may, as a consequence, find their progress limited to the rank of a senior or semisenior. Unfortunately the literary styles of English which we are sometimes encouraged to emulate in our liberal arts training are not what is necessary for communication in business. Here straightforward, simple, clear, direct English with enough life and interest to hold the attention and convey the meaning is a requisite. Forms of reports used by others may serve as a guide, but boredom may be avoided by a judicious use of novelty and originality. The ability to write with crystal clarity is as much an auditor's responsibility as is the proper presentation of financial statements.

Analysis and Constructiveness.—Through education, training, and experience the auditor may build up sufficient knowledge for his needs, but he must have natural analytical ability to ferret out the necessary facts, and he must have constructive ability to weld from the facts convincing conclusions useful for those seeking light about business.

QUESTIONS

1. What is meant by an audit?
2. Who does auditing in the United States?
3. Why should management be interested in auditing?
4. Of what interest to creditors are certified reports?
5. Why are certified statements becoming more and more essential?
6. What is meant by a detailed audit?

7. What effect does subdivision of labor and internal check have upon the type of audit performed?

8. What is test checking?

9. What is a continuous audit?

10. Define a balance sheet audit.

11. What type of audit would you recommend where fraud is suspected?

12. Enumerate various investigations which may be performed by auditors.

13. How may the public accountant be useful in tax work and in system work?

14. Discuss the duties of principals, supervisors, seniors, semiseniors, and juniors.

15. What are the necessary qualifications of an auditor with regard to personality, education, and ability?

CHAPTER II

RESPONSIBILITIES OF AUDITORS

Public accountants have relations with (*a*) other accountants, (*b*) clients, and (*c*) the public. In all these dealings they should be guided not only by legal requirements, which are often not particularly rigid, but by the best sort of ethical and moral responsibility befitting an American professional gentleman who aims always to do the right thing according to a well-developed conscience. An intelligent accountant who behaves in this manner will usually find little difficulty in fulfilling his obligations. The Rules of Professional Conduct of the American Institute of Accountants should always be in mind.

RELATIONS WITH OTHER ACCOUNTANTS

Adherence to the tenets of the Golden Rule will in most cases result in the accountant's having pleasant, satisfactory relations with his fellows. A junior should remember that his senior is responsible for doing his assignment well and quickly; therefore, the junior should do everything possible to assist him in this purpose. Seniors and supervisors should be good teachers; they should be able to instruct others simply, clearly, patiently as to what, in their judgment, is wanted. They should remember that they, too, were beginners at one time and that the reason they at times failed to do good work was that they did not know how to proceed. Just as a so-called "teacher" may be the ruination of a pupil, the accountant in charge may fail to bring out the best that is in an assistant. The senior who develops out of promising material good, efficient workers for his office is a man of inestimable value to his organization.

Principals and partners should see to it that personnel is chosen with care and discretion. They do no favor to a young man by hiring him if he has no reasonable chance of being successful in his work. They waste his time and cause him to try to find another position after having tasted the defeat which accompanies failure. The goose step of modern mass education tends to pro-

duce failures, because all persons are not naturally endowed with the ability to progress at the same rate. A slow starter with an even, dogged pace may in the long run outdistance the flashy sprinter. The principal should so far as possible attempt to see to it that each individual beginner is given an opportunity to march forward according to his natural ability. He will thus reduce his labor turnover and tend to have a happy, contented staff which will do its work efficiently. As far as possible he should try to give security of employment at fair wages and offer ambitious young men every possible opportunity to secure the advancement which every normal person craves. As long as most American businesses use the calendar year for their fiscal period and wish to have audited statements as of the end of the year, public accountants will continue to feel the exhausting pressure of an intensely busy season extending from fall to spring. Only those vigorous enough to endure this grind should be permitted to engage in it. During the slack season, opportunity may be afforded to direct the education and improvement of the younger staff members and to catch up with reading designed to keep one abreast of changes in a swiftly moving profession.

Besides overseeing the multitudinous details of a busy office, the most outstanding leaders of the profession seem to find abundant time to give attention to the general progress of this particular field. They take active part in the doings of their state societies and participate in the numerous avenues of development of their national body, the American Institute of Accountants. Books and articles are published, speeches both of general and technical interest are made, and valuable discussions are entered into with a view toward settlement of disputed issues. Generous donations of money are often given for the good of the cause. The ramifications of accounting are so extensive that truly the young accountant can make only a commencement toward mature development while in school; even the principal must throughout life exert himself constantly in order to maintain his standing among his fellow practitioners.

RELATIONS WITH CLIENTS

In dealing with clients, it is well for the accountant to put himself constantly in the place of the client. The work should be done so as to disrupt as little as possible the natural orderly

conduct of the business of the client; the effectiveness of the client's staff should be enhanced rather than harmed by the fact that an audit has taken place. Contractual relations should be so clearly and simply defined as to avoid, so far as is humanly possible, occasion for misunderstanding and dispute; the general legal responsibility is to do reasonably well that which is naturally to be expected from a professional man such as the accountant purports to be. He should, however, always have it in mind to be as helpful and productive as possible in all directions. Above all, under no circumstances should he divulge his client's business secrets or talk unnecessarily about the client's affairs or employees.

RELATIONS WITH THE PUBLIC

Accountants themselves have led the public to believe that it may have confidence in statements certified by them. They should do everything possible to lead the public toward justified conclusions and turn it away from mistaken notions. This requires great care and skill in the use of the spoken and written word. In the public mind accountants have at times been deemed the acme of accuracy, mathematical wizards, inhuman by never being in error. It should be clearly pointed out, however, that they have been endeavoring for many years to publicize the idea that accounts are not exact and that any statements of operation or financial condition are only approximate and the most that a public accountant can offer is an informed opinion on the accounts. In order not to deceive the public, accountants must be circumspect in all their dealings with their fellow men. Frequently public accountants are referred to as independent public accountants, and this the public expects them to be in all important respects. In this connection, Accounting Release No. 2 of the Securities and Exchange Commission states: " . . . an accountant cannot be deemed to be independent if he is, or has been during the period under review, an officer or director of the registrant or if he holds an interest in the registrant that is significant with respect to its total capital or his own personal fortune." The chief accountant of the S.E.C. in Accounting Release No. 22 ventures that "When an accountant and his client, directly or through an affiliate, have entered into an agreement of indemnity which seeks to assure to the accountant immunity from liability for his own negligent acts, whether of omission or of

commission, it is my opinion that one of the major stimuli to objective and unbiased consideration of the problems encountered in a particular engagement is removed or greatly weakened."

Although the accountant is not an insurer or guarantor and is expected to do nothing but give his conclusions and opinions, he must morally and legally have good and sufficient reasons for his decisions or meet the condemnation of those with whom he has no contractual relationship but who, nevertheless, have relied upon him. During these last few years the requirements of the stock exchanges and the S.E.C., particularly in Regulation S-X, have focused the attention of public accountants on their responsibilities to the public. If the accountant contracts with the client to do less than will reveal the facts which the public should have, the public is not well served and actionable fraud may result. But, after all, will the truly professional man with a conscience such as we expect of him often fail in these particulars?

THE CERTIFIED PUBLIC ACCOUNTANT

The public has assumed the responsibility of protecting itself somewhat in dealing with the work of public accountants. Legal cases attached to this chapter will give a working idea of the attitude of the courts toward the accountant's performance of his duty. In every state and in the District of Columbia, laws exist requiring certain tests to be met before one is authorized to hold himself out as a Certified Public Accountant (C.P.A.), and in some states no one can practise even as a public accountant without meeting stipulated requirements. Laws of this latter type are known as restrictive legislation. Just as physicians, dentists, and lawyers must receive authority from the state before they may engage in the practice of their professions, so also must accountants receive permission, usually from a state board, to use the title "Certified Public Accountant." The implication is that the state certifies that such persons have at least a certain minimum of ability upon which the public may rely; in states where public accountants are not required to be certified, voluntary choice may be made and a person lacking this qualification is sometimes engaged. New York and Massachusetts are states which still retain the earlier type of nonrestrictive law; anyone may practise public accounting there, but only those who have received their state certificates may call themselves certified. In Illinois, on the

other hand, no person may hold himself out even as a public accountant without meeting the state's requirements, and still more stringent stipulations must be met by the Certified Public Accountant. In Michigan, only the certified may practise.

Since a firm may not usually call itself one of Certified Public Accountants unless all its partners are certified, he who hopes to advance to the top of his organization should attempt to qualify for that distinction as soon as reasonably possible. It may also help him to impress his employers with his financial importance to them and may save his employers embarrassment when clients ask, as they sometimes do, whether employees are certified. It may have a psychological effect in assisting the employer to obtain reasonable compensation for services rendered. There are, however, numerous able public accountants who have not been certified, and, as in all lines of endeavor, not all of those who have technically qualified do as good work as may be desired.

The young man desiring to be certified should ascertain the requirements of his own state. He must comply with the law of his state and with the regulations issued by his state board under provisions of that law. Usual minimum requirements for taking the examination or receiving the certificate are that the candidate be

1. At least twenty-one years of age
2. A high-school graduate or its equivalent
3. A person with some public accounting experience, running generally from 1 to 5 years.

New York and New Jersey now require graduation from an approved school of accountancy after a 4-year course in an approved high school. They even stipulate the minimum number of semester hours of study of accountancy, law, finance, and economics the candidate must have had as a prerequisite. If one receives his C.P.A. in one state, he may, if he complies with the reciprocity clause of the law of another state in which he wishes to practise, receive permission to practise as a C.P.A. there.

The examinations used by about 45 of the state boards to test the candidates for the C.P.A. are prepared by the board of examiners of the American Institute of Accountants. Although the Institute is equipped to grade the examinations as a service to the state boards, in some states the papers are graded locally. Other states, not using these examinations, prepare and grade their own.

Institute examinations are available in May and November of each year. They can be seen conveniently, with unofficial answers, in issues of *The Journal of Accountancy*, the monthly organ of the Institute. The various state boards are composed of men appointed by the respective governors from among certified public accountants, and occasionally a lawyer; such boards usually charge a candidate a fee of $25 for taking the examination.

Although some of the examinations prepared by the states have an additional section on economics, the Institute examinations cover only accounting theory and practice, commercial law, and auditing. In the morning the candidate writes from 9 A.M. to 12:30 P.M. on auditing. The same afternoon he writes on accounting theory and practice—Part I, from 1:30 to 7:30 P.M. On the following morning he writes on commercial law from 9 A.M. to 12:30 P.M., and he ends that day with accounting theory and practice—Part II, from 1:30 to 7:30 P.M. The examination is a long, hard grind, and a relatively small proportion succeed in passing all of it at one sitting. *The Certified Public Accountant*, a bulletin of the American Institute of Accountants, for July, 1941, submits the following information:

EXAMINATION RESULTS

The papers of 694 candidates who sat for the Institute's examinations on May 15th and 16th in 28 states and 2 territories which have adopted the Institute's standard examination have been graded by the Institute's examiners.

The results, as reported to the state boards in June, showed that 53.5 per cent were passed in auditing, 52.7 per cent were passed in commercial law, and 18.3 per cent were passed in accounting theory and practice. At the November, 1940, examinations 21.6 per cent were passed in auditing, 45.3 per cent were passed in commercial law, and 9.7 per cent were passed in accounting theory and practice.

737 candidates took the Institute's examinations in 7 other states and the District of Columbia which do not submit papers to the Institute's examiners for grading.

The total number of candidates taking the examination was 1,431.

Seven states which regularly adopt the standard examination did not hold examinations in May.

Because of the severity of the examination, a majority of the states permit a candidate otherwise successful to retake one or more parts of the examination without additional fee, provided he comes up for reexamination within some such reasonable time as a year or two.

Opinion varies as to whether the young graduate should attempt the examination almost immediately upon leaving school or whether he should acquire 2 or 3 years of experience and maturity before subjecting himself to the test. The writer has seen success achieved under both plans. He is inclined to say that it depends on the particular man in question and the training he has had. It is often claimed that failure in the examinations is because of poor preparation, which is doubtless an argument of some validity. The opinion is, nevertheless, ventured that a candidate may quite likely find one set of examinations rather than another more suited to him and his preparation. One outstanding American accountant, a senior partner in a public accounting firm, took the examinations three times before meeting success. An ambitious, able candidate with the courage of his convictions should, it surely seems, remember the old adage, "If at first you don't succeed, try, try again."

THE AMERICAN INSTITUTE OF ACCOUNTANTS

A candidate who passes his C.P.A. examinations, graded by the Institute's own examiners, has passed one of the hurdles prerequisite to joining the Institute. If his papers have been graded locally for the C.P.A., arrangements may usually be made to forward them for a verdict as to whether they satisfy the requirements for membership in the Institute, which was formed in 1916

> To unite the accountancy profession of the United States; to promote and maintain high professional and moral standards; to assist in the maintenance of high standards for the certified public accountant certificate in the several states; to safeguard the interests of public accountants, to advance the science of accountancy; to develop and improve accountancy education; to provide for the examination of candidates for membership; and to encourage cordial intercourse among accountants practising in the United States of America.[1]

Candidates for admission as members must, upon passing the examinations, be elected by the council. They must be certified and must have been in public practice not less than 5 years before the date of application. Applicants for admission as associate members are required to have 2 years of public practice and a C.P.A. certificate. Members and firms of which all partners are members may designate themselves as Members of the American

[1] By-laws of the Institute.

Institute of Accountants. Those who expect to devote their lives to public practice should naturally join with their fellows for their common good and advancement, and they should seek to take active part in the affairs of the Institute, for in so doing they will surely strengthen themselves in many ways and make of themselves more successful practitioners. Membership in the local state societies of certified public accountants is also desirable.

QUESTIONS

1. What principles should public accountants keep in mind to insure pleasant relations with other accountants?

2. Why must principals use care and discretion in choosing personnel?

3. In dealing with clients, what is the proper attitude for a public accountant to take?

4. How can accountants better their relations with the public?

5. What are the laws in your state governing the use of the title "Certified Public Accountant"?

6. What are the requirements for candidacy for the C.P.A. examinations?

7. What material is covered by the examinations prepared by the American Institute of Accountants?

8. When should a young graduate attempt the C.P.A. examinations?

9. What are the purposes and aims of the American Institute of Accountants?

10. What are the requirements for membership in the Institute?

CHAPTER III

BEGINNING THE AUDIT

THE INITIAL STAGES

As has already been seen, an audit is generally performed with some more or less definite object in view. This object should be clearly kept in mind particularly throughout the initial stages. It will enable the accountant to visualize what the client wants and needs and what must probably be done to fill the assignment. Of course, if an accountant has served a client over a period of years, they may have grown to understand each other to such a degree that oral arrangements may be entirely sufficient. Even a telephone call may be the only necessary precursor to the commencement of work. Benefiting by his past experience, the auditor may be able to carry on the work with a minimum of conscious planning.

If the assignment is the first one for a new client, a good maxim to remember is that "Haste makes waste." How can one plan to do an efficient piece of work unless he thoroughly understands what is to be done? How can he know what the job should reasonably cost unless he knows what is to be involved in doing the work? The first thing to do, therefore, is to learn as quickly as possible the essentials of the business. Although the fundamentals of business are largely the same everywhere, there are differences in their applications which unless recognized may lead to difficulties. An accountant, being human, cannot know all about everything. However, an intelligent, experienced public accountant will easily adapt himself to most situations and understand their essentials with relatively little effort. In most instances reports of previous auditors are helpful. All accountants should, nevertheless, be aware of the fact that the American Institute of Accountants has published the *Accountants' Index*, which, with its supplements, attempts to list everything that has been written on accounting. Before inclusion in the supplements, current literature is listed monthly in *The Journal of Accountancy*. Surely some of the references listed in this mine of information will

throw needed light on any phases of business with which the accountant is not sufficiently acquainted. If a senior is in charge of an engagement involving an industry with which he is not familiar, it is necessary for him to prepare himself by studying the general problems of that industry, not merely the accounting phases.

In addition to thinking over the situation and reading all pertinent matter, it is well for the public accountant to go through the plant and office and obtain an idea of the accounting system in use and the amount of internal check before committing himself as to just what sort of job is to be done and what the cost may be. Some public accountants require their clients to submit answers to a rather elaborate questionnaire on internal control before beginning the audit. Accounting Release No. 19 of the S.E.C. contains the following helpful suggestion:

> . . . for new and unknown clients some independent investigation should be made of the company and of its principal officers prior to undertaking the work. Such an inquiry should provide a valuable background for interpreting conditions revealed during the audit, or, in extreme cases, might lead to a refusal of the engagement.

Probably the prospective client will be more receptive to questions at this stage of the proceedings than he will be later. In brief, the accountant should try to obtain as thorough a knowledge of the situation as possible in order that he may have reasonable grounds on which to base decisions. There is always a question as to whether it is safe to audit the accounts for a given period if they have not previously been audited by a reputable person upon whom the accountant can rely. In cases of this sort it is necessary to investigate, think about, and discuss the figures compiled at the beginning of the period in question to be sure that there is a firm base upon which to do the current work. For one thing the accounts must be on a comparable basis in order to reflect properly the earnings of the intervening period. If they are not, the auditor must make suitable adjustments. Fortunately an adequate audit of the current period will throw a good deal of light on figures inherited from the past. However, it may be necessary to make at least a rough survey of such matters as the property accounts from the beginning of the business if one is to certify to them now. He may then agree to do for a flat fee the work which appears to him to be necessary. This plan will

probably be preferred by the client because of its definiteness; or he may undertake the work on a per diem or daily basis, charging perhaps $15 to $25 per day for juniors, $25 to $40 for seniors, and $50 to $100 or more for principals. The latter arrangement is fairer to the accountant, since no matter how thoroughly he may study the situation in the first instance he will undoubtedly run into unexpected complications during the course of the work and must allow for them. The above per diem rates may seem excessive, for juniors may be paid from $75 to $150 per month and seniors $150 to $400 per month, but it must be remembered that a good deal of idle time is to be expected in most offices and that there is a substantial amount of overhead connected with every employee working in the field. When the work is done at the client's place of business located at a distance from the accountant's office, it is customary for the client to be charged with the traveling expenses of the accountants and with a reasonable allowance of perhaps $5 to $7 per day per man for hotel accommodations. If unmarried, the young accountant, when traveling out of town on assignments, has, therefore, only his room expense in the office city to bear.

Generally the accountant does not enter into a formal written contract with the client; an oral arrangement is quite customary. However, upon the accountant's return to the office after having entered into such an agreement, in order to avoid disputes it is usually wise to send a letter of confirmation stating as specifically as possible what the accountant understands the essentials of the undertaking to be. It is well to ascertain definitely for whom the work is to be done and who is obligated to pay for it, since experience shows these matters to be fruitful sources of embarrassment. A copy of the confirmation or an office memorandum should be filed to apprise the organization of the work to be done. In the initial stages of the arrangements it is well for accountant and client to agree where and when the work is to be done. If the accountant rushes into the client's place of business ready to begin work without having made previous arrangements, he is likely to find himself unwelcome, and he may find no satisfactory, comfortable workroom available. Loss of time and a disappointing beginning of the audit may result. An audit, so well planned in all its phases in advance that everything goes along smoothly and efficiently, with a minimum of friction and less occasion for

disgruntled feelings, is usually much more satisfactory in all respects. In fact if the engagement is well planned it will ordinarily be possible for the client's staff to have properly sorted and ready for use trial balances, lists, schedules, checks, vouchers, and books; such planning will enable the accountant to do his work more expeditiously and, therefore, at less cost to the client.

If the job must be finished by a certain time, it may be necessary to engage in overtime work. Not only must arrangements be made to have the client's quarters available after usual business hours, but the client should understand that 7 hours (9:00 A.M. to 5:00 P.M., with one hour out for lunch) constitute a day's work and that he is to pay pro rata for overtime service rendered. The client may also be charged a dollar or two per man for dinner money under these circumstances.

The senior in charge should appear at the office of a new client with a letter of introduction, after having learned as much as possible about the audit from conversation with the principal and from reading all the memoranda and correspondence available. For repeat engagements he should prepare himself by studying the material in the permanent file concerning the engagement and the working papers for the preceding period. The permanent file contains all material pertaining to the various businesses audited which must be used on audits of them year after year. It is a necessary part of every audit program.

PLANNING THE WORK

When work is to begin on the assignment, it may be put in charge of a senior by the office manager, if that is the custom, or by a principal or supervisor. Sometimes the office manager picks the juniors who are to work on the audit, whereas in other offices the senior is allowed to choose from available juniors. Both methods have their advantages.

The person in charge, supervisor or senior, must decide what the various persons who work on the assignment are to do and when it is to be done. In other words, he must have an outline of the work to be done. Practice differs as to programs; naturally, each firm thinks its method best. Some accountants have a complete program on file from which the items to be done on the particular assignment are ticked off, thus producing a procedure to be followed on the job in hand. In other cases the supervisor

or senior prepares a program from his experience without checking against any previously prepared. Then again the accountant in charge may not prepare a program in advance but may allow it to grow as the work progresses. The various workers sign for the part of the work which they perform and for which they must accept responsibility, or the items are ticked off and the accountant's initials appended as the work progresses. In general, checking against a rather complete program listing everything that might be done on practically any audit is probably most helpful, since it may call to mind important matters that might otherwise be overlooked. The person preparing the schedule of work should profit from the initial survey made at the time the job was accepted.

The auditor should plan to come to his work well supplied with columnar, text, graph, and scratch paper, pens, pencils, erasers, clips, and forms. He will do well to carry his papers in a stout leather brief case provided with an adequate lock. In the eyes of the client's staff, he is the acme of precision and care, and he must in all possible ways live up to this conception.

THE WORKING PAPERS

The public accountant makes a record of the job on working papers which furnish the information for the building of the report at the completion of the audit and are also the evidence of work performed. Generally these papers are reviewed by supervisors before they will assume responsibility for the assignment, and they may be reviewed by principals who wish to note how well assignments are being done by the organization and whether there is a basis for signing the firm name to the report. Working papers are the most concise form yet devised for recording the progress of the work. Skill is required to prepare them quickly and properly, and skill is also required to read them quickly and intelligently so that weighty decisions may reasonably be made from a study of them. The working papers are compiled where the audit is made, which is usually the client's place of business. Sometimes on repeat audits it is possible to prepare parts of the working papers on the typewriter at the accountant's office before going out on the job.

The backbone of the working papers is some sort of trial balance. This is usually entered on a columnar work sheet, often

referred to as a working trial balance, which has appropriate columns on the right for necessary adjustments and for the final adjusted statement or statements. If a preclosing trial balance is used, it will give rise, after adjustment, to both balance sheet and profit and loss statement figures. Because of the length of such a trial balance in a large business, sometimes it is advisable to begin one working trial balance with the unadjusted balance sheet. This will then be adjusted during the audit, giving rise to a balance sheet which it is thought may reasonably be certified. Another working trial balance may then be used to do comparable work for the profit and loss figures. If the books have been closed prior to the commencement of the audit, it may be advisable to make the postclosing trial balance as shown by the books the basis of the audit; after this is entered on the working trial balance sheet, an adjusting entry can be made reversing the closing entries and thus in effect give a preclosing trial balance as the foundation for carrying forward the work of the audit. Next to the column containing the figures for the present period which are to be verified, a folio column may be provided to show their individual places in the ledger. The figures should also have a column close to them in which reference can be made to the schedules showing the work done upon each of them.

The number of columns on the working trial balance paper will vary with firm policy and procedure. It is customary to insert in columns to the left of the figures on which the present audit is to be based the corresponding figures of the previous period. This arrangement allows the auditor to make useful comparisons before he has proceeded far with his work, and it may show him important changes which suggest points to be emphasized in his audit. He may wish to draw up a where-got where-gone statement, as Professor William Morse Cole of the Harvard Business School used to call it, or a tentative statement of source and application of funds to bring out the changes more sharply. All this work tends to make the auditor better acquainted with the business and with those aspects to which he should devote special attention.

All the working papers should be thoroughly cross-indexed for ready reference. For example, take a typical asset to be audited, such as Cash. Page 6 of the ledger may be referred to as being the page of that book upon which the account stands. The

schedules for the work on Cash may be denominated under the letter A, and reference to A will be close to Cash on the working trial balance. Typically, several schedules will be necessary to show all the work done in verifying Cash. The leading schedule for Cash may, therefore, be A, and it may be supported by subordinate schedules lettered A_1, A_2, A_3, etc. These schedules should refer to each other, be thoroughly cross-indexed, and should refer also to the page of the working trial balance, if that is long enough to require several sheets of columnar paper. Besides this method of indexing, there are various others in use. One numbers primary schedules consecutively and attaches letters alphabetically to subschedules. Another letters the master schedules alphabetically and adds another letter for subschedules. It would be possible to number the main schedules, letter subschedules, and number sub-subschedules. It is frequently found that accountants label assets with a single letter and liabilities with a double; thus Cash is A and Accounts Payable, AA. Supporting schedules may then be shown either by a small letter or a number. Any of these methods and others just as good or better may be adapted to the needs of the individual office.

While the auditor is working upon an item such as Cash, it may well be that certain things which are wrong will, in his opinion, need adjustment. The adjusting entry may be entered on the schedule upon which he is then working, put also in a list of adjusting entries which will bring all these matters together, and entered on the working trial balance to bring the preliminary figures nearer to what should be certified. Then it is well to have the working trial balance indicate opposite the adjusting entry the designation of the schedule which showed its origin; this is helpful in tracing the entry easily and quickly from the schedule to the list of adjusting entries or to the working trial balance. Numbering these entries assists in this respect. If an auditor is working with a preclosing trial balance and finds an error, he may have to construct one adjusting entry to correct the preclosing trial balance and a different entry to be handed to the client's accountant to be made upon the client's books; they have probably been closed by that time in order that the bookkeeping for the ensuing period might go forward without delay. In that case the auditor might well have one list of adjusting entries to be used for his own work and another list to bring the client's books to a proper basis

for the figures for the following period. If the auditor suggests changes to be made upon the client's books, in his next audit he will want to see whether these changes have been effected or whether he must again make allowance for these errors before he can arrive at figures to be certified. One practising accountant says, "I think it is a cardinal principle that the auditor should never release the certified statements until he is certain that any adjustments reflected therein have been recorded on the books."

It is a good practice to use one sheet of schedule paper for each aspect of the audit. The back of the sheet is not customarily used. This procedure makes it easier to find a desired item. Naturally, all scheduled work should be headed for proper identification. In general, schedules should begin with book figures and work from them to the figures believed to be correct. It is necessary to have each of the schedules contain a brief statement of the work done and a notation of who did it and when. Should any question arise later as to any part of the audit, inquiry can easily be directed to the person assigned to it. It should be remembered that the senior should be able to understand what the junior has been doing from an inspection of the latter's working papers. Likewise, the principal should be able to review the work done on the whole audit by studying the working papers for the job. Next year the man assigned to the job should be able to see what was done a year ago if he looks through the papers. In case of dispute or litigation, these papers contain the story of what was done; they should show whether enough was done and whether the right things were done. Since these papers are the history of the work performed, they should be compiled with care. Each schedule should be consistent with its related schedules. If a schedule for a reserve shows an addition to the reserve through a charge to expense, the schedule of expenses should also note the charge. In some offices so much importance is attached to the working papers that they are prepared in ink. Others feel that this slows up the work unreasonably and, therefore, allow them to be made in pencil; nevertheless, the trend is to be more and more insistent that they be neat, helpful records of the work done. The working papers belong to the auditor and are a means to an end.

In all his work the young public accountant should strive to keep his mind flexible. No matter where, how, or what he studies, he will probably find different applications of fundamental princi-

ples in practice. These should not disturb him. If, for example, the office where he secures employment has its own well-developed method of indexing, it is hardly proper for him to suggest that the system which he learned in some text be adopted, unless experience proves that the present system has definite, serious deficiencies as compared with the one he originally learned.

QUESTIONS

1. What should one keep particularly in mind throughout the initial stages of an audit?
2. Why is it important to learn the essentials of the business being audited?
3. Of what use is the *Accountants' Index* in connection with an audit?
4. What items should receive particular care in the initial stages of a first audit?
5. Does the accountant enter into a formal written contract with the client?
6. What preliminary work may be done by the client's staff?
7. Who plans the work and decides what the various persons are to do? How does he make sure that all necessary details are covered?
8. What supplies should the auditor carry to the audit?
9. What are working papers and where are they compiled?
10. What is a working trial balance and how many columns should it contain?
11. Discuss methods of indexing the working papers.
12. How should the auditor handle any necessary adjusting entries?
13. How should schedules be laid out to show the desired figures?
14. Should working papers be prepared in ink?
15. To whom do the working papers belong?
16. Why should a young accountant strive for flexibility?

PART II

AUDITING PRACTICE AND PROCEDURE

CHAPTER IV

AUDIT OF CASH

The following chapters on procedure constitute a program for a balance sheet audit of a typical industrial concern of moderate size. Departures from usual procedure to cover situations where the internal check is unusually good or bad will be specifically noted. In the preparation of these chapters constant use has been made of the pamphlet *Examination of Financial Statements by Independent Public Accountants*, a bulletin prepared and published by the American Institute of Accountants in January, 1936.

As has been noted, most fiscal years end on December 31. Since it is obviously impossible for the auditor and his staff to be at the offices of all his clients at the close of business on that date, he will have to postpone work on some engagements until a later date; in fact, he may not be hired to perform some of the audits for the year ending December 31 until a month or two in the new year have elapsed. Of course, it may be possible to do a substantial part of the audit work throughout the year, even for a business which uses the calendar year for its fiscal year. In one large public accounting firm 75 per cent of the inventory work on quantities and circularization of receivables is done at some date other than December 31. When the auditor arrives to begin the actual work of the audit, he should, as far as possible, find everything in readiness for him to proceed with his work with dispatch. At some previous time, arrangements should have been made to have canceled checks put in order by the client's staff; to have in readiness schedules which the client's staff is capable of making, such as lists of securities and notes receivable; to have available cash reconciliations for the various months of the year in question, if they have been prepared; and to have ready for inspection important legal papers, contracts, and agreements. The more of these necessary things that have been done by the client's staff, the less time (at probably a much higher rate of remuneration) will the public accountant's staff have to spend. Any business does well to reconcile its cash promptly upon receipt of the bank statements.

PURPOSE AND EXTENT OF AUDIT OF CASH

Now for what purposes is the checkup on cash to be made? In the first place, the amount of cash on hand as of December 31 should be ascertained, because it is to be included in the certified balance sheet. Then again, the amount of cash that should be there must be verified. When deciding what to do to satisfy himself in these two respects, the auditor should first ask himself whether there is a good bookkeeping system, well kept by competent help. Next he should determine whether there is a good system of internal check, so that no manipulations and peculations can be carried on by one person without coming soon to the attention of one of the other workers, who in the absence of collusion would probably report it. If both are satisfactory the audit can reasonably be quite restricted. If, in addition, a fairly independent internal auditing force has done a good job of checking throughout the year, a still more restricted examination may be adequate. In the typical balance sheet audit it is fairly customary to make extended tests of original documents, entries, postings, and footings for a selected month or two of the year. Because of year-end manipulations, which practice proves to be unusually prevalent, special attention is devoted to the last month and particularly to the last few days of it and the first few days of the ensuing period. The weaker the system and the internal check, the more the accountant should be inclined to feel that a detailed examination of all the transactions for all the months should be made.

COUNTING THE CASH

In well-run businesses most cash should be in bank. Except for cash to make change and to meet small expenses not important enough for checks to be drawn, the general rule is that all cash received should be deposited daily in bank, and all disbursements of cash should be by check. Then total receipts should agree with total deposits, and amounts drawn from the bank should agree with cash-paid records. Reconciliation of these matters should be made for a month or two of the period as a test. This rule sometimes is not practical; if cash transactions are few and the bank is some distance away, it may be that two or three deposits a week will be more sensible than a special trip to the bank every day. However, the possibility of depositing by mail should not

be overlooked. Now, the cash that was in bank at the end of the year is known by the bank and its December statement will show this amount. If this statement is received directly by the public accountant so that it is not subject to erasure or alteration, it may well serve the needs of the auditor when he is counting the cash on the day with which the statement ends. It is, however, customary for the accountant to request a confirmation of the cash balance directly from the bank. Well toward the beginning of the actual audit work the senior in charge may send for confirmations from banks. Standard forms for this purpose are available, but thought should be given to the fact that more than cash balances will usually need to be ascertained from banks. Nobody likes to be pestered day after day by a request for this and a request for that; so in one letter the aim should be to ask for all requisite information. This will include such items as balances of all separate accounts, commercial, savings, and special; notes held for collection and their status; loans from the banks, if any; and collateral held against loans.

If, besides change and expense funds, other cash is on hand, it should be counted. All cash funds on hand should be kept by the imprest system. Since there is the possibility that the cash may have been built up temporarily to meet a particular need by some such device as borrowing against marketable securities, it is wise to have under control simultaneously all cash and near-cash items. This may in some cases be accomplished by physical possession and in other cases by sealing part in a vault while the rest is being verified. As the cash is counted, it should be recorded on a schedule in detail. Should it seem desirable, a second count, by way of surprise, may later be taken to check against shortage or manipulation. All cash counts should be carried out by the public accountants in the presence of the cashier or some other person responsible for it. Custom decrees that when the cash is passed back to this person upon the completion of the work, his receipt for the amount involved, properly dated, should be obtained in order to free the accountant from liability. If an audit is being performed for a year ending, say, December 31, and the auditors are not able to appear on the job until a later date, it will be necessary to count the cash at the latter time. Confirmations should be received from all banks as of the date of the cash count, and reconciliations as of that date should be made. Having

found what purports to be the correct cash balance on that date, it will be possible to find the year-end cash balance by adding to the former the cash disbursed since the year's end and subtracting cash received between that time and the date of the count.

Checks returned by the banks should have been entered in the cash-paid records. By comparing them individually, outstanding checks shown by such records will be revealed. In the next examination, or preferably when the bank statement for the next month is received, if the audit is still in progress, it should be noted whether these outstanding checks have since been paid. Care should be taken to ascertain whether unrecorded outstanding checks were also paid by the bank, thus throwing light on the reliability of the records. Action should be taken on long-outstanding checks. Payment may perhaps be stopped on them, the cash debited back on the books, with the offsetting credit showing either a still-continuing liability or an addition to surplus or current earnings, as seems advisable.

RECONCILIATION OF CASH FIGURES

The cash counted should then be compared with the amount shown by the ledger balance. If the latter purports to show both cash on hand and in bank, probably it will not immediately agree with the total of cash on hand and in bank and it will, therefore, need to be reconciled with them. It is furthermore probable that neither the ledger balance nor the total of counted cash and the cash balance as reported by the bank will reveal the true cash figure for the end of the fiscal period. The ledger balance may not contain deductions for such things as bank charges, which are sometimes learned about only when the bank statements for the period are received. Amounts of notes may not have been added to the ledger balance if the bank effected their collection toward the end of the period and advice of this fact was not received until later. On the other hand, the bank balance may show too large a figure because of outstanding checks which have not as yet been cleared. Because of facts such as these, there are a variety of ways in which accountants prefer to reconcile the figures. Some like to start with the ledger or book figure and reconcile it with the bank figure and the counted cash; then they proceed to bring the total for the latter to what they regard as being the true cash figure to be certified. Others prefer to begin with the figure as reported

by the bank. To this they add the counted cash, if any. This result they first reconcile with the ledger figure, which in turn is brought to the true figure. Still others feel that if they bring both the figure reported by the bank (including any counted cash) and the one shown by the ledger, each independently, to one figure representing the correct cash balance on the given date, they have a useful check on their work.

PETTY CASH

The accounts for the various petty cash funds, if they are kept as suggested by the imprest system, will usually reveal round figures. Unless they have just been replenished, however, the petty cashier in charge of any one of the funds will be able to answer his accountability, not by producing cash exclusively for the full amount, but by showing some cash and some vouchers for amounts expended. However, the auditor should not allow expenses paid to be reported as cash, unless they are so immaterial as not to merit attention. It is much better to have the petty cash funds replenished as of the end of the period and to have the general cash account reflect the payment of all expense items.

MISCELLANEOUS CASH ITEMS

During the cash count miscellaneous items ordinarily found with the cash, such as checks, should be specially noted. They should be listed and compared with records of cash receipts, in order to ascertain that they have been entered before the close of the fiscal period. It may be that memoranda for cash spent will be found among the items counted as cash. Ordinarily they must be included both in the cash-received and in the cash-paid records. Advances to employees may be represented by memoranda or by their personal checks. The accountant should see that such checks are deposited in bank and are paid to the bank before he completes his audit. If they prove worthless, they should not be included in the cash and the amount involved should be treated as a receivable from the employee, as would be the case when only a memorandum was taken from him in exchange for the cash advance. The procedure used for employees' checks should also be used with checks that have been cashed as an accommodation for persons other than employees.

If miscellaneous cash is found on hand in businesses where it is the custom to deposit all cash receipts promptly, it should be given special attention. Unclaimed wages and other sums owing to employees should be checked against prior records and their disposition discussed by the senior with a proper official. If the amounts on hand are from miscellaneous sales to employees, or others, they should be checked against available records and deposited. Other sums, for example, rent received, should be compared with rent receipts, correspondence, and leases, and promptly deposited.

CASH MANIPULATIONS

Frequently cash manipulations are found as of the end of the period, and the auditor should do everything possible to guard against them. He must be particularly careful of the cash cut-off; only cash on hand on a given day may be certified as being on hand. The cash inflow and outflow for the last few days of the period under audit and the first days of the period following should be carefully watched. Entries purporting to be offsetting or correcting should be scrutinized carefully. A check may have been drawn on one bank, not recorded as cash paid, and may have been deposited in another, the result being that total cash in the two banks is overstated. This may be caught by careful scrutiny of outstanding checks when later returned by the bank, but the kiting will probably be noted sooner if detailed inspection of deposit slips or duplicates obtained directly from banks is made. If the check were drawn and cashed, the amount being added to cash on hand to cover a defalcation, the overstatement of the true cash balance might be found only when canceled checks were later returned by the bank. If it were added to cash on hand to make a more impressive total of cash available, scrutiny of the recorded cash received might reveal this manipulation. There may be receipts recorded on the books toward the end of the period which are said to have been deposited in bank too late for their inclusion in the bank statement. These should be noted as receipts on the next bank statement (which the auditor himself should secure) if the audit is still being performed when it arrives, or inquiry as to this deposit should be made of the bank, preferably at the time of asking for all other necessary information. Unusual items on the bank statements are frequent sources of useful information.

It is good practice to check the composition of deposits for the last few days of the period, as shown by deposit slips or duplicates received directly from banks, with the cash shown to have been received by the cash-received records. Failure to agree exactly may indicate that the actual receipts were deposited but were reported on the books as being received for other reasons, the cash originally received for these reasons having been stolen. If these actual receipts are entered in the books at the beginning of the new period before the amount stolen has been replaced, a surprise count and reconciliation would reveal the shortage. Good internal check would, however, prevent this practice since the person actually handling and stealing the cash would not have access to the records to such an extent that he could manipulate them and tend to hide his fraud.

Checks returned by the bank should be scanned for such items as cancellation, amounts payable, signature, and endorsement. Discounts given and received should also be verified. The seasoned accountant can usually tell by a mere glance whether they are in order. It is the custom to tick them or stamp them as they are examined, in order to prevent their being presented a second time. Endorsements may show whether employees have improperly come into possession of the money represented by the checks. All checks should be accounted for serially. Checks made payable to something not purporting to be a person are ordinarily payable to bearer and should have close scrutiny as to who got the money and why.

BALANCE SHEET AUDIT VERSUS DETAILED AUDIT

The student will undoubtedly ask himself where a balance sheet audit ends and where a detailed audit begins. To this question it is impossible to give a completely definitive answer. On a balance sheet audit under one set of conditions more or less can and should be done than on one under far different conditions. A restricted audit of the balance sheet type is ordinarily sufficient to produce reliable statements for stockholders and creditors. For other needs more or less will be required to do a satisfactory job. The public accountant, supposed to be an educated, intelligent, professional man of experience, is bound to determine reasonably well what constitutes a suitable and sufficient program to meet the particular needs of a given assignment. He performs a detailed

audit when he finds it necessary: to go back to such original records as those of purchases, sales, payrolls, cash received, and accounts payable; to check these individually one against another as far as possible; then to check them minutely against entries on the books of original entry; then to compare postings on the ledger one by one with entries in the original records of account, verifying footings and crossfootings meticulously as he proceeds. He is definitely not relying upon the bookkeeping system and the internal check to produce figures accurate enough to be certified with limited, restricted tests and checks.

A detailed audit as to cash would attempt to ascertain that all cash which should have been received was recorded on the books as received and, perhaps, deposited in bank. Every item might have been followed individually, or, more reasonably, adequate tests and samples of the detail might have been deemed to have been sufficient. Amounts due from customers or others would be compared with the sales records and with the cash received, and confirmation of amounts still due would probably be confirmed by direct correspondence. Discounts apparently allowed would receive close scrutiny, to ascertain whether in all cases they really were. Disbursements would be noted, and sufficient reason would be sought for them all individually or by sampling. For example, not only would bills for merchandise be carefully scrutinized, but also receiving records, purchase orders, and requisitions would all be inspected and cross-checked. All cashbook totals and footings would receive detailed consideration and verification. Discounts apparently not taken would be checked back to terms of purchase and dates of payment. If the enterprise audited were of any size and the auditors attempted to do all the detail, the cost would be prohibitive and the time spent unduly long. Even our detailed examination would necessarily have to be limited to tests.

CASH AS A CURRENT ASSET

Cash is usually shown as a current asset upon balance sheets. Since current assets are customarily compared with current liabilities, the implication is that these assets in the amounts stated are able to meet presently maturing obligations. No cash out of harmony with this concept should be certified as current. Cash not available because the bank has closed should, for example, be shown as an "other asset," and probably a reserve should be

provided for the loss involved. If under agreement some cash is to be used for a particular purpose, this restriction prevents it from being considered current. If a bank is about to offset cash on deposit against a note due to it, generally the cash is not free to be used to meet current obligations. Money held under a certificate of deposit may not be current, either because of the time to elapse before it will be available or because the certificate has been endorsed to another party as security. It is an old English custom, not generally permitted in the United States, to allow persons in certain circumstances to overdraw their accounts. This is one method by which a bank might make a loan to a customer. An auditor should, therefore, not permit an overdraft on one bank to be merely deducted from the balance in another. Furthermore, if the auditor finds that checks payable have been drawn and entered as cash credits, but not sent out by the end of the period under audit, the cash involved should be shown as on hand. Otherwise the current ratio might perhaps be shown as better than it actually was, and the auditor might well find later that as an afterthought it was decided not to send out the checks.

When showing the cash as of a given moment of time, it is not enough to show what it might have been if certain things had happened. Receipts and payments effected after that moment were not part of the showing then. However, it must be borne in mind that balance sheets cannot be accurately said to be actual, distinct, and clear photographs of definite mathematical certainties. They are built too largely upon historical concepts and opinions for that. Therefore, we need not split hairs. Unimportant matters should not receive too much time-consuming and expensive attention. The aim is to certify statements which are informative and from which proper conclusions may be drawn. Suppose, by way of illustration, that a business has cash on deposit in a foreign country. If it is relatively insignificant in amount, too much care would not be justified as to the conversion rate and the position of the item on the balance sheet. On the other hand, if the amount was large and it was converted at the current rate, even though actually received much earlier by the company, it might give rise to an important unrealized profit which, according to accounting conventions, rules, and practices, had better not be taken until actual realization. If a substantial loss, how-

ever, was involved it would be much better to be able to recognize both the fact and the amount and to make adequate provision for it. No matter what the amount was finally determined to be, if there were withdrawal restrictions, generally it would not be free enough to meet current obligations in this country. Nevertheless, it would probably be free to meet current obligations in the country where it was. The accountant would have to give all these matters the attention which he deemed reasonable under the circumstances of the audit before he would be in a position to certify. *Research Bulletin* 4 of the American Institute of Accountants deals with the foreign exchange problems arising out of war conditions.

QUESTIONS

1. What may a client do to expedite the auditor's work, and why is it essential that this be done?
2. For what two purposes is the checkup on cash made? In this connection what should the auditor ask himself in deciding what to do?
3. What is the typical balance sheet audit of cash?
4. Why should special attention be paid year-end cash transactions?
5. Where should most cash be in a well-run business?
6. What should an accountant do about confirming a bank balance?
7. Discuss the technique of cash counts.
8. What are the various methods of reconciling cash?
9. What are the duties of an auditor in connection with an imprest petty cash system?
10. Discuss the procedure to be followed in auditing miscellaneous cash items.
11. What may the auditor do to guard against cash manipulations?
12. What are the differences between a balance sheet audit and a detailed audit?
13. What would a detailed audit of cash attempt to ascertain?
14. Since the aim of the auditor is to certify statements which are informative and from which proper conclusions may be drawn, what particular points should he bear in mind in showing cash on the balance sheet?

CHAPTER V

AUDIT OF SECURITIES

PROCEDURE

Some securities or investments are found among the assets of practically all businesses. They may, for example, be stocks, bonds, receivables, notes, mortgages, insurance policies, or agreements showing participation in outside activities, such as partnerships. The desired end so far as the balance sheet is concerned is to certify to the correct quantity and amount of these investments.

If examination of the internal check, the operation of the system in general, and the books and records themselves provides data believed to be reliable in these respects, the book figures should be checked against physical counts of the securities on hand and against confirmations of securities in the possession of others. The income from securities as revealed by the books should be compared with the income expected by the terms stated in the securities and will, of course, provide, partially at least, the background necessary to the certification of this item in the period's statement of profit and loss. Since the audit of income substantiates the amount of the securities, some check of it should be made even in an audit where it is desired to report only upon the balance sheet. The young auditor should endeavor to develop facility in causing work which he does in certain parts of his procedure to throw light upon information which will be needed at other points.

In a balance sheet audit the incidental tests of income necessary for the certification of the securities on the balance sheet may be sufficient for him to certify the income from them. If, however, no great reliance can be placed on the figures, either because of the absence of provision for internal check, or because of the poor system of accounts installed, or because of the loose and slipshod manner in which the system is actually being operated, much more detailed work will have to be done before reliable figures may be available. This may take the form of verifying all existing

evidences of purchase and sale, such as comparing brokers' statements with the books of account; noting in each case the corresponding receipts and payments of cash; testing the results against the figures on tax returns submitted to the government; noting meticulously securities given or received as collateral; counting, confirming, and doing everything else possible to show the true status under the conditions existing in the business being audited.

Since public accountants so often come in contact with various types of investments and securities, their advice as to financial matters is often sought and, since a good understanding of finance will frequently enable them to see implications in the figures which would otherwise be overlooked, a thorough, practical knowledge of finance, particularly as related to the corporation, should be obtained by the accountant as early as possible in his career; this will be enriched by profiting from experience throughout the years.

List of Securities.—The client should be asked to have ready for the auditor a list of securities, together with sufficient detail. If this seems impossible, the accountant may well prepare such a list as the basis of his audit. Details which he will find useful may include accurate descriptions of each and every security; the income to be expected; the interest rate on notes, bonds, and mortgages; and the dividend rate, if any, on stocks. Care should be taken to note the face amount or denomination of bonds and the types of stock. Cost, book values, and market quotations (when existent) should also be shown. Notation of interest and dividends actually received from them during the period under audit may be informative as to their value. The location of all securities, whether on hand or in the possession of others, will be useful as a guide in counting or confirming. If they are in the possession of others, the reason may be enlightening; it may, perhaps, reveal a liability for which some security is serving as collateral. Comparisons of a list of this sort with corresponding lists used in prior audits may indicate changes suggesting cash received and paid, exchanges, and other transactions requiring attention. Lists prepared by the client's staff should be compared with the book accounts, and the basis on which the securities are carried there should be investigated.

Comparison of Lists with Actual Count.—After the lists have been used to give a general acquaintance with the investment

situation and to furnish suggestions toward a program for their audit, if none has previously been prepared, the count of the securities on hand should be compared in detail with these lists. To prevent making good shortages in one asset by substitution of another, all securities should be counted simultaneously with the cash. A representative of the client should be continuously present during the count. It is good practice to receive from this person a properly dated and signed receipt for the assets turned back to him when the count has been completed.

The closer in point of time the count may be to the balance sheet date, the less numerous will the adjustments be to arrive at the balance sheet figure. Inspection and count of the securities on the balance sheet date are more convincing than notation later that securities, which probably must have been among the assets on the balance sheet date, have been sold. If they were there, they might have been in the physical possession of others to whom they were hypothecated. The auditor not only must ascertain the existence of an asset, but he must also try to learn whether it is an asset without strings attached to it or whether it has been pledged for some specific purpose and is not, therefore, freely available for the general and ordinary uses and needs of the business. The securities counted should be subjected to close examination. For one thing, it should be noted where the title apparently is; the securities should, unless bearer paper, be in the name of the business under audit, or they should bear adequate endorsement capable of transferring title, or they should be accompanied by proper, separate powers of attorney for the same purposes. When looking at the securities, the auditor should almost unconsciously be asking himself whether they appear genuine and what they purport to be or whether they provide a clue to something worthy of his future investigation. If stock certificates are not in the name of the business, it may be fitting to ponder why they are not and certainly it should be noted whether dividends which should have been received from these investments have actually come in from those in whose names they stand. Bonds registered as to principal and interest would be in the same position. All unmatured coupons should be attached to bonds not registered as to interest. Audits have been lost through failure of auditors to note that coupons of this type were missing.

Certificates not on hand may be absent for a variety of reasons: they may have been sold, hypothecated, loaned, or merely out for

transfer. If sold, the consideration for them should be evident. Direct confirmation should be obtained from the pledgee if they serve as security for a loan, and the auditor may well question whether the pledgee is a proper one. In the case of a loan, the propriety of making the loan should be as important as the confirmation of the fact that it has taken place. Confirmations from transfer agents sometimes involve a cost which may seem prohibitive. Actual receipt of the certificates from them a few days after the date of the audit may occasionally obviate the necessity of this expense.

Mortgages.—The inspection and count of such securities as mortgages may offer some difficulty to the beginner. For one thing he must know what to inspect. Although there are some technical legal differences throughout the United States, reference to the rather clear-cut, definite practice which prevails in such places as Massachusetts, New Hampshire, Maine, and Illinois may be helpful to him. In these jurisdictions the most important paper concerned with mortgages is a promissory note. This, among other things, shows what is to be paid and when, and it refers to a mortgage deed which provides security or collateral for the note.

The mortgage deed in Massachusetts is not conditional; it is absolute. It conveys title to the security to the mortgagee (the noteholder) and ordinarily contains a power-of-sale clause which, in the event of default, either in making the stipulated payments on the note or meeting other stated obligations such as paying taxes, keeping the security in good condition, or providing adequate insurance, permits the mortgagee after due notice to sell the property, title to which he has for his protection, and apply the proceeds to his note as far as may be necessary. If the foreclosure sale yields more than enough to meet the note, the excess usually should be given to the mortgagor. On the other hand, should the sale yield less than enough to meet the note, the balance or deficiency is still due and payable by the mortgagor to the mortgagee; in fact, he may sue for it in court. Although mortgage deeds in Massachusetts do convey title to the mortgagee for his security, they contain a defeasance clause which nullifies the conveyance if the obligations in the note and deed are fully complied with. However, it is well to secure a discharge of the mortgage from the mortgagee when he has received satisfaction and to have it recorded in the county records.

In the event that it is a question of a real estate mortgage, the real estate, title to which has been given as security, is of course subject to the hazard of fire. To save the mortgagee harmless if a fire should destroy the security, it is customary for the mortgagor to provide an adequate fire insurance policy payable in case of loss to the mortgagee. In case a policy is in force when the loan is effected it is practice for the insurance company to attach a rider making the policy payable in case of loss to the mortgagee "as its interest may appear." Occasionally a mortgagee requires that he be protected from other hazards, such as hurricanes or damage by aircraft. Loans secured by personal property, ordinarily called chattel loans, may be protected by still other sorts of insurance. By way of illustration, it would be sensible to protect with collision and theft insurance a loan secured by an automobile. In Massachusetts, therefore, the auditor checking investments should inspect the notes, the mortgage deeds, and the insurance connected with each mortgage.

In New York, instead of the note and mortgage deed it is customary to speak of the bond and mortgage. Instead of using a note promising that a given amount will be paid at a given time, the borrower acknowledges that he is well and truly bound unto the mortgagee in a given amount to be paid at a given time. The New York mortgage, following the same practice as that found in Michigan, Wisconsin, California, and the majority of the United States, does not convey the legal title to the property used as security to the mortgagee; it confers on the mortgagee merely a lien which is personal property in his hands. The mortgagee must usually ask the court for its approval and assistance in foreclosing the mortgage before the security may be sold and the proceeds applied to the debt. In some states, even after foreclosure, the mortgagor is given by law a period within which he may make payment and redeem his property.

In the states where the mortgage conveys title to the mortgagee, the latter is the legal owner of the property, and the mortgagor, for the time being at least, is only the holder of an equitable interest. However, the mortgagor is the owner against all the world except the mortgagee, and, therefore, the auditor is justified in showing the mortgaged property as an asset of the mortgagor, although the fact that it is pledged should be clearly indicated.

Transfers Relating to Real Estate.—The auditor should also be aware of the fact that it is customary to make public record of

transfers relating to real estate. It is the intention that the public shall rely on the public record as to the state of the titles. If, for example, one is considering making a loan with real estate as security and he finds no record of any mortgage against the property in the registry, he is justified in believing that he will have first claim against the property if he makes the loan and records his mortgage promptly. Any other existing mortgage, which of course has not been recorded, will have a claim against the property ranking after the recorded mortgage, regardless of when it came into existence. If the investment being audited purports to be a first mortgage, then the auditor should note the fact that it has been recorded, which ordinarily can be ascertained by seeing a stamp on the face of the mortgage deed giving the time and the book and page of the record. It would also be advisable to see correspondence from legal counsel stating that in their opinion the recorded mortgage was a first mortgage because they had found no other mortgage on record and they had found a good conveyance of title to the mortgagor which he was in a position to convey for the protection of the present loan. It is not part of the auditor's work to check the public records; this work is properly within the province of the lawyer, and an auditor who attempts to engage in it in behalf of his clients may find himself being prosecuted for unauthorized practice of the law. However, correspondence from lawyers, title policies, and abstracts of title which may show useful information are used by public accountants as an essential part of their audit procedure.

Life Insurance Policies.—The beginner may have particular difficulty also in auditing life insurance policies. Since everyone would be better off if he had at least a working knowledge of this subject, and particularly since an auditor must be able to deal with it understandingly, some consideration may perhaps justifiably be given to it here. Essentially there are two sorts of life insurance: term and endowment. The term policy pays only at the death of the insured and only if the death occurs during the stated term of the policy; it may well be compared with a fire insurance policy, which pays for damage by fire only when it occurs during the period when the policy is in force. After the period for which it is written, the term policy is ordinarily worthless from a monetary point of view. Here, again, it is like the fire policy. The term policy provides protection only and has no element of

saving connected with it; this policy, therefore, has no loan value or cash surrender value to be shown as an asset. The only asset value in connection with it to which the public accountant ordinarily certifies is for the deferred charge for premiums paid in advance.

Endowment policies, on the other hand, combine protection and saving. Straight life policies should be included with endowment policies for our discussion, since they are nothing but endowment policies written to mature at a ripe old age. The premiums on such policies are large enough to pay for the needed protection through the years and to create a savings fund. It is this savings fund which may be had as a cash surrender value, if one chooses not to carry the policy longer. It also usually measures the amount which may be borrowed with the policy as sole security. Accountants should accordingly expect to certify to cash surrender values of straight life and endowment policies.

Although the amount of cash surrender and loan values is customarily stated in the policies, at least for the first 20 years, it is good practice to confirm the amounts with the insurance company. They may give information concerning outstanding loans not apparent from a mere reading of the policies. Of course the concern under audit must be the beneficiary under the policy, or the cash surrender value is not an asset to it. If the insured has retained the right to change the beneficiary, which may happen, the asset is not certain enough to be certified.

Loans for which the policies have been pledged as security must be confirmed with the insurance companies. The amounts can be verified directly in no other safe way, although the existence of them may be evident from stamps on the policies indicating that they are pledged or by the fact that the policies are in the physical possession of the insurance companies. Ordinarily the loans should be shown as liabilities, not merely deducted on the balance sheet from the cash surrender value, unless it is definitely intended not to pay them off. Since cashing the policies and borrowing upon them are not the main purposes for which life insurance is carried upon its officers and executives by American businesses, the cash surrender values are not usually shown as current assets.

Sinking Funds.—In the event that stocks, bonds, or other securities comprise funds which have been built up for specific purposes, the auditor should check the amounts on hand in the

possession of such persons as trustees against any existing agreements. If, for example, the conditions of a bond issue are such that a sinking fund is to be created to retire the bonds, the auditor must note the requirements of the bond indenture as to the sinking fund. Noncompliance with such conditions is sufficiently important to require comment in report or certificate, since it may be that it causes the whole issue to become immediately due and payable; a result such as this might seriously affect the financial condition of the business under audit. The same considerations should be given to agreements connected with the sale and issue of stock, particularly preferred stock, whereby a fund is to be created for the redemption of part or all of the stock sold. In some cases the business may be practically a trustee for sums contributed by employees, and perhaps also by itself, to a pension fund. Investigation should be made to ascertain that the fiduciary responsibility is being properly met. The care and attention being given to these fiduciary obligations may well give the auditor a general understanding of the business audited, which will enlighten him as to the course to pursue throughout the audit. If these funds are with trustees, reports from them should be examined and confirmation may reasonably be obtained directly from them.

Investments in Partnerships.—Since the audit of investment notes receivable is similar to the audit of other notes receivable, and the audit of fixed assets held for investment is comparable to the audit of other fixed assets, special attention will not be given to them here. Should investments in partnerships be encountered, considerable judgment may have to be used as to their disposition. How much work to do will depend to a large extent upon their significance. In some cases, it is conceivable that an audit of the partnership's books may be necessary. Then again, sufficiently reliable statements of the partnership may be available; they and the records of the amount invested and other correspondence may lead the auditor to believe that he has enough information for certification.

POSITION ON BALANCE SHEET

After having checked the securities and investments, the public accountant must give suitable attention to their location on the balance sheet. Two groups of securities may reasonably be shown among the current assets: dealers in securities ordinarily put their

inventory there, usually abiding by the customary rule of using the lower of cost or market as the basis; those securities which represent merely temporary investment of excess cash funds, which will in the ordinary course of business be converted back into cash, may be included there also. In fact, the latter are practically so near to being cash that they should probably stand next to it within the current asset group.

Securities, other than inventory, shown with the current assets are for most purposes best shown at the lower of cost or market. Cost is satisfactory if market fluctuations from it are not great. It is preferable that both cost and market be indicated in some acceptable manner upon the balance sheet, even though only one can be used as the stated amount for the asset.

Some securities and investments may be held to secure control of other companies. Others are for other business reasons, such as furnishing funds to suppliers; the income from these, if any, is usually of minor significance. To part with securities of these types might be practically impossible because of the disturbance to the business relations among the companies. They are, therefore, permanent assets, which have no place among the current assets. It is usually proper to include in a separate grouping securities which the business cannot market readily for any reason. Fund investments should be shown separately on the balance sheet or included with permanent investments under a proper heading.

It is usually acceptable to show at the cost of acquisition long-term investments in stock of other companies. However, if it appears, either from market quotations, audits, the study of available statements supported by correspondence, or inquiry from responsible officials that the investments are worth substantially less than the consideration given for them, it is necessary to indicate this fact adequately in the balance sheet; in some cases a reserve for the shrinkage may be deemed the best method of disclosure. Permanent holdings of bonds are usually shown at cost or, sometimes, at amortized values. Indications of market values also may sometimes be helpful.

If treasury stocks are among the investments verified, consideration should be given as to whether they should appear in the balance sheet as assets or be deducted from corresponding liabilities. Although temporary holdings for a specific purpose may be

countenanced as assets, they should be shown as a separate group and not as current assets; such disposition will facilitate ease of identification. The cost, as well as the face value of bonds, and the number and par value of shares of stock should be shown. A notation of market value should also appear if feasible. When subtracted from items on the liability side of the balance sheet, consideration of all pertinent facts, including the laws of the state where incorporation was effected, will be necessary to determine the nature of the deductions. Treasury stock may in some cases properly be deducted from the outstanding capital stock, or from surplus, or from both in suitable proportion and either at par or cost as the case may be. Since outstanding bonds are usually shown at face, treasury bonds should be deducted from them at face.

It is always important that any restrictions upon the free use of assets be noted; otherwise, the reader of the balance sheet may be led to draw erroneous conclusions. Hypothecations are clearly within the scope of this rule.

QUESTIONS

1. What types of securities may be found among the assets of many businesses?
2. What is the first step in an audit of securities?
3. Of what value would it be to check the income received from securities?
4. In case a detailed audit seems to be required, what procedure should be followed in an audit of securities?
5. Of what value would an understanding of finance be to an accountant?
6. What information should be included in the list of securities?
7. How should this list be verified with the securities on hand?
8. Describe the procedure to be followed in auditing mortgages, differentiating in your discussion the mortgage deed in Massachusetts and the bond and mortgage in New York.
9. How much checking should be done by the auditor in connection with transfers relating to real estate?
10. What two main types of life insurance are there?
11. What should the accountant do in connection with cash surrender values?

12. How should loans for which insurance policies are pledged be audited and shown on the balance sheet?

13. Discuss the procedure to be followed in auditing sinking funds and any other fiduciary obligations.

14. What groups of securities may reasonably be shown among the current assets?

15. At what value should securities ordinarily be shown on the balance sheet?

16. What consideration should be given to treasury stock if it is among the investments verified?

CHAPTER VI

AUDIT OF ACCOUNTS AND NOTES RECEIVABLE

ACCOUNTS RECEIVABLE

Balance Sheet Presentation.—For the balance sheet the auditor must ascertain the amount of accounts receivable which may reasonably appear. These accounts usually arise in the ordinary processes of trade and are payable according to the credit terms of the business under audit. Accordingly, it is generally to be expected that they will in large part be current assets and should be shown commensurate with their ability to meet current liabilities or, in other words, at a figure denoting their estimated collectibility. Other accounts receivable may also be in evidence; they may be due from officers, employees, affiliates, or others. Some of these may be found to be current assets also. In that case they should be valued as above. Those which are not current may be investments or other assets and should be considered both from the point of view of the value to be placed upon them and the place where they should appear on the balance sheet. Large current accounts receivable, not arising through trade and from transactions at arm's length, should be shown and designated separately, since current accounts receivable without further designation are usually understood to be trade receivables.

Noncurrent accounts receivable, if collectible, are commonly valued like current receivables; however, if they are in the nature of investments of a permanent type, it may better serve the purpose to show them at full face value, except when the business in which the investment was made has suffered substantial losses, in which case a reduction in the investment should be indicated. All amounts due from affiliates and any large extraordinary items require separate disclosure.

Usually no income from accounts receivable will be found. If there is any, however, it may throw some light on the value and currency of the accounts. For example, if interest is being received on accounts receivable, they are probably in arrears.

Generally speaking, the longer the period that ensues, the less likelihood there is of ultimate collection. The receipt of interest on an advance to another company may indicate the value of the investment.

Current accounts receivable should usually be collectible within a year at the longest. In the case of installment receivables it is sometimes trade custom to show them as current assets, even though part may not be collected within the year. If the amount not due within a year is substantial, indication of the fact should be on the balance sheet. If income from installment sales is fully taken when the goods are shipped, consideration should be given as to whether future expenses of handling and collection should be charged against this income, a reserve for the future expenses to be created and to appear on the balance sheet. The whole machinery for handling installment sales, including the security for the accounts and the manner of handling delinquents and repossessions, should be studied for whatever evidence it may afford as to the probability of collection and the size of necessary reserves.

Any receivables pledged or assigned as security for a debt should have an indication of that fact attached to them, since otherwise the reader of the balance sheet may well believe that they are available for the general purposes of the business. Receivables discounted should not appear as assets, but evidence of any contingent liability connected with them should appear upon the balance sheet.

Initial Stages of Audit.—How may the accountant know whether the accounts receivable are valid? Most of them should arise through sales. Records of sales, shipments, returns, and allowances, therefore, are one source of information. In the course of a detailed audit these might be investigated individually, or at least extensive tests might be made of them in order to insure that every charge against a customer represented a claim that should be collected. Less detailed checking would be needed and a balance sheet audit would be feasible if the internal check was good; if sales, shipments, returns and allowances, and cash receipts were recorded by different persons so that nobody could falsify his returns without revealing an obvious discrepancy between his figures and those of the others. A few random short periods might be tested in detail, to make sure that the internal check was

working efficiently. At any rate, experience teaches that special and careful consideration should be given to transactions during the last few days of the audit period and the first few days following. In a survey of this part of the work evidence calculated to arouse suspicion should be investigated thoroughly.

Confirmation of Outstanding Accounts.—Besides the information to be derived from a study of the books and records, there is always the possibility of obtaining confirmation of the debt directly from the debtors. For several reasons this has not been done as frequently in the past as it might have been. Creditors, by way of illustration, were afraid of what debtors might think concerning them and the state of their business and records, if the customers were asked to confirm what was owed. Accounts receivable are such an important asset in many businesses, particularly from the credit point of view, that there is a noticeable tendency among public accountants to require direct confirmation as a condition precedent to unqualified certification of the accounts. Experience seems to indicate that generally confirmation is both practicable and reasonable. As the custom becomes more general, there will doubtless be less objection to it. The American Institute of Accountants' "Extensions of Auditing Procedure," published in October, 1939, contains the following pertinent paragraphs:

RECEIVABLES

In regard to the question of confirming receivables by direct communication with the debtor, the following recommendation is made:

That hereafter, wherever practicable and reasonable, and where the aggregate amount of notes and accounts receivable represents a significant proportion of the current assets or of the total assets of a concern, confirmation of notes and accounts receivable by direct communication with the debtors shall be regarded as generally accepted auditing procedure in the examination of the accounts of a concern whose financial statements are accompanied by an independent certified public accountant's report; and that the method, extent, and time of confirming receivables in each engagement, and whether of all receivables or a part thereof, be determined by the independent certified public accountant as in other phases of procedure requiring the exercise of his judgment.

Procedure.—As a first step in his audit of the accounts receivable, the public accountant should obtain from the client's staff, or prepare, a list of all balances open on the audit date. The lists

should be footed and the total compared with the totals in any controlling accounts kept; any discrepancy should be investigated; in fact, it may indicate a lax system or one poorly kept and the necessity for much detailed checking before the auditor is satisfied. The list should be compared in detail with the customers' accounts in the ledger. Since these lists will be in the auditor's hands after the balance sheet date, he will be able to find—by a perusal of the cash-received records, or the customers' ledgers, or both—whether any of the balances then outstanding were since paid. In the usual case, evidence of such payment may support the contention that the account existed and that it was good. If any credit balances are found in the lists, it is generally good practice to show them on the balance sheet as accounts payable rather than as deductions from the amounts to be collected. In dealing with accounts payable, any debit balances should similarly be treated as receivables.

Although the auditor may be able to satisfy himself as to the total amount due in each case, he still is under the necessity of determining the probability of collection. Aging of the balances is often of assistance. If old items remain unpaid when current items are being paid, the unpaid items are perhaps the subject of dispute. Past experience of the business and others like it may throw light on the situation. Perusal of credit correspondence and proper inquiry of the credit department and responsible officials may be helpful. A sufficient reserve should be deducted from the bad and doubtful current accounts receivable on the balance sheet to indicate what is expected to be collected.

Not only should the auditor see to it that all claims against others get into the records, but he should also investigate to see whether all cash that should be received from these claims is received, recorded, and deposited. He must remember the possibility that cash has been received and stolen, the account being credited as worthless or for some allowance. Therefore, close watch should be given to ascertain that all write-offs of presumably worthless accounts have been properly authorized, preferably by one not handling cash. Similarly, credits for unusual discounts and other allowances should be carefully checked. When one person records cash receipts only and another lists incoming cash, the possibility of stealing part of it is diminished, but, unless attention is given to terms of sale, there is still the possibility that

customers will be credited for discounts to which they are not entitled. Unless the system provides adequately for a check of discounts granted, the accountant should give them suitable attention. Discounts and allowances of all types affect the amount to be collected on accounts, and appropriate reserves should be provided for them.

The ordinary account receivable arises from a sale; if the sale has not been effected, there is no receivable. Goods on consignment have not been sold; they still belong in the inventory of the consignor and are in the hands of another to be sold when occasion arises. Mere shipments to agents or branches have, in at least one instance in the past, been reported as sales giving rise to receivables, which, of course, they are not.

When is a sale a sale? There are at least three alternatives: (1) when the contract is entered into; (2) when the goods are shipped; (3) when the goods are received and accepted. Although the auditor will usually abide by customs established in important lines of trade, he will generally consider the receivable valid when the goods are shipped. This procedure appears to be a practical, happy medium. Goods not shipped, therefore, have not been sold, have given rise to no receivable, and form part of the inventory. Although the passing of title is useful evidence, it is not always controlling as to whether it is reasonable and sensible to consider a sale as consummated from an accounting point of view. Care should be taken to see that no sales subsequent to the period under audit and no receivables arising therefrom are included in the audited statements.

NOTES RECEIVABLE

Under this caption promissory notes receivable and their equivalent will be treated. When a draft is drawn and the drawee accepts by writing his name across its face, the drawer has in effect a promissory note payable to him. If the acceptance arises out of an ordinary merchandise transaction, it is a trade acceptance. In case a bank accepts, it is a bank acceptance. All these promises are in writing, which helps somewhat in their verification.

Procedure.—A list of all notes receivable on the balance sheet date, prepared if possible by the client's staff, should be obtained; it should contain such useful information as dates of making; due

dates; names of makers, payees, and endorsers; amounts; and interest rates. This list should be compared with ordinary book records or with special note registers, if any. The notes themselves may be on hand or in the hands of others. If the former, they should be inspected carefully and checked in detail against the list; if the latter, scrutiny of income received from notes may indicate their amount. The auditor cannot know positively from mere inspection whether signatures and endorsements are genuine, but the intuition born of experience may sometimes give rise to well-founded suspicion calling for further investigation. Due dates may indicate that notes no longer on hand have been paid, in which case receipt of the cash should be investigated in the cash records for the period following the balance sheet date. Even though notes are inspected, present practice is to confirm them with the debtor. All notes actually in the list or which should be there should be accounted for suitably. Notes receivable, investments, and cash should be inspected or controlled simultaneously, to prevent substitution. Confirmation should be obtained from banks holding notes for collection at the same time that they are asked to confirm cash balances. Attorneys holding notes for collection should be asked to confirm directly the amounts of the notes and their progress in collection. Any notes discounted should not only be confirmed by the discounting banks, but the cash received from them should be checked and adequate disclosure of any contingent liability connected with them should be shown.

Books on accounting give the impression that there is no contingent liability connected with notes which have been discounted "without recourse."

The Uniform Negotiable Instruments Act states specifically in section 65:

> Every person negotiating an instrument by delivery or by a qualified endorsement, warrants: (1) That the instrument is genuine and in all respects what it purports to be; (2) That he has a good title to it; (3) That all prior parties had capacity to contract; (4) That he has no knowledge of any fact which would impair the validity of the instrument or render it valueless. But when the negotiation is by delivery only, the warranty extends in favor of no holder other than the immediate transferee. The provisions of subdivision three do not apply to persons negotiating public or corporation securities, other than bills and notes.

Unless, therefore, the transferor at the time of the sale of the note expressly refuses to warrant, there may be a contingent liability for which the accountant should make provision, even if notes were negotiated without recourse. Notice of payment of the note by the maker would ordinarily be necessary before such liability could reasonably be deemed to be extinguished.

Balance Sheet Presentation.—When the amount of notes receivable has been ascertained by inspection of them and the record of them, by consideration of their income, and by receipt of confirmations, there remains still the necessity of deciding about their collectibility, *i.e.*, the amounts at which they should be shown and their position on the balance sheet. Attention should be given as to whether partial payments have been made; notations to that effect may not appear on them. Some evidence of what the notes are worth may sometimes be obtained from collateral on hand as security. The fact that collateral was required may indicate that the makers were not too sound financially, and may, therefore, show that the notes are worth no more than the collateral. The value of the latter should accordingly be checked against market quotations or other available evidence.

Because they are in writing, notes receivable are commonly thought to be superior to accounts receivable. However, when an account receivable is not collectible, the creditor may take a note for the amount rather than get nothing. Such notes are no better than the accounts, if as good, and require special investigation of their worth. When a note becomes due it may be renewed; the renewed note may be even less collectible. The source of all notes should, therefore, receive attention, to the end that reasonable values may be placed upon them and proper reserves or allowances for loss created.

Since notes customarily run for a longer time than accounts receivable, the latter usually follow cash in the current asset group. The notes, being less liquid, customarily come next. Interest receivable accrued should also be shown as a current asset. Only notes receivable due within a year are ordinarily grouped with the current assets. Trade practice sometimes dictates that notes, especially installment notes, with longer maturities be included in the current group. If they are large, indication of the facts should appear upon the balance sheet. Notes receivable should be treated in detail on balance sheets of businesses whose

sales are largely of the installment type; their importance in the financial setup warrants it. Notes received from persons directly connected with the business should be separately disclosed on the balance sheet and should receive special attention during the audit. The reasons for their existence and evidence of manipulation should be sought, especially in regard to transactions immediately prior to or following the date of the balance sheet. Suitable investigation should also be given to notes arising from transactions which are outside the ordinary course of the business under audit; they also should be shown separately on the balance sheet. Notes of affiliates must always be stated separately; they are current only when the affiliate is in a position to pay them and they are due within a year; otherwise, they may be investments or "other assets."

CONFIRMATION OF RECEIVABLES

At the conclusion of the auditor's work upon receivables, it is good practice to ask a responsible official of the business audited to confirm the results. If he hesitates, it may suggest further work to be done by the accountant. Confirmation by a company official will not relieve the auditor from the responsibility of making a reasonably good investigation; however, it may lead to helpful information, and it insures the active cooperation of the client.

QUESTIONS

1. How should trade accounts receivable, installment receivables, and pledged receivables be shown on the balance sheet?
2. What are the initial stages in an audit of accounts receivable? Distinguish between a balance sheet audit and a detailed audit in this connection.
3. Should the auditor confirm all outstanding accounts receivable?
4. What is the first step in the audit of accounts receivable?
5. What verification should be made of customers' accounts in the ledger?
6. How should credit balances be shown?
7. What should the auditor do in estimating the probability of collection of the outstanding accounts receivable?
8. How can the auditor check on possible manipulations in connection with accounts receivable?

9. Discuss the accounting for goods on consignment.

10. Discuss the alternative methods of booking sales.

11. What is meant by a note receivable, and what types are there in common use?

12. What information should the auditor's list of notes receivable contain?

13. What is present practice with regard to direct confirmation of notes receivable?

14. Discuss the liability connected with notes discounted "without recourse."

15. What consideration should govern the balance sheet presentation of notes receivable?

16. Why is confirmation of receivables by a responsible official of the business audited desirable?

CHAPTER VII

AUDIT OF INVENTORIES

The audit of inventories requires especially careful attention from the independent public accountant. Frequently the inventories are the most important current assets; an erroneous statement of them may not only mislead the reader of the balance sheet as to their ability to help meet current liabilities, but it may also lead to a showing of unwarranted profits for the period ending on the balance sheet date. Then again, inventories are among the least current of the current assets, since they must usually be converted into accounts receivable before they can result in cash with which to pay debts, and frequently further processing is necessary before they are even ready for sale. Although it is extremely important that the inventories be reasonably stated, even the most experienced auditors cannot be thoroughly familiar with the millions of different items which compose them in various businesses. Since, then, they are likely to be of great importance and the auditor may know little about their components, he should be ever on his guard.

VERIFICATION OF QUANTITIES

The auditor must first satisfy himself as to the quantities to be regarded as assets on the balance sheet date. Since he may be dealing with quantities of many different things, such as merchandise, raw materials, goods in process, finished goods, and supplies, he must adapt his technique to them. He must verify the credibility of the inventory representations made to him by others.

The clerical accuracy of the inventory count must be established. The public accountant must study the method and procedure used for taking the inventory to see whether it provides its own checks and whether, if followed, it would lead to inventory quantities upon which reliance could be placed. A detailed written statement as to the method followed should be obtained from a responsible official. Some companies have such data in

mimeographed or printed form. Although it was believed until recently that a study of inventory procedure and records, together with additional information received from responsible officials, would be all that was needed to satisfy the public accountant as to quantities to be certified, it is now believed that the auditor should not limit his examination to these three. In the absence of book inventory records, his presence and participation in the count is especially desirable; his inspection of what is counted may be helpful even though he does not pretend to be expert as to the things counted. When he cannot be present at the physical count, test checks of the physical stock at a later date with proper adjustments for purchases and sales since the date of count may prove fruitful; however, in that case the certificate or report will usually have to be qualified. Until each business adopts the natural business year for its fiscal year, the pressure of work at December 31 may be so great that it will be impossible for public accountants to be present while the physical count of inventories is being made in the places of business of all their clients who do not have satisfactory book inventory records. However, C. Oliver Wellington in an article entitled "Experiences with Extensions of Auditing Procedure for Inventories," which appeared in *The Journal of Accountancy* for July, 1940, says:

> All accountants were somewhat worried about their ability to carry out the extended auditing procedures regarding inventories because so many clients close their books at the end of the calendar year. However, this difficulty seems to have been overcome by careful planning of the work.
>
> Study of the conditions affecting each client indicated that in many cases clients were operating a system of perpetual control of inventories through adequate records, tests of which could be made at odd times prior to the close of the year that would justify the auditor in relying upon the stores records so tested as a basis for determination of the inventories total at the close of the fiscal year.
>
> In cases where it seemed necessary or desirable to take complete physical inventories, arrangement was made in many cases to take such inventories prior to the close of the year, the auditor making sufficient tests of the inventory taking and then supplementing these by tests of the transactions between the date of the inventory taking and the close of the fiscal year.
>
> In our own firm, at staff conferences in each office we reviewed the situation affecting each important client, decided what steps were desirable, and then endeavored, in cooperation with the client's employees, to undertake the work necessary at various dates prior to

December 31st. As the result of such planning there was actually very little inventory work remaining to be done on that date.

Incidentally, for some of the clients of our firm, and for those of a number of other accountants who have given me the benefit of their experiences, consideration of the whole problem of inventories resulted in developing methods which were of distinct value to the clients. By careful planning it was possible in many cases to reduce the time when the plant had to be shut down, thus minimizing loss of production and the corresponding loss of profits.

In "Experiences with Extensions of Auditing Procedure and Papers on Other Accounting Subjects," presented at the fifty-third annual meeting of the American Institute of Accountants, 1940, Prior Sinclair states:

Review of the experiences of numerous accountants with extensions of auditing procedure with respect to inventories indicates:

1. Generally in only relatively few cases involving very valuable materials and under circumstances where substitution is not difficult need the accountant, due to his lack of qualifications as a general appraiser, valuer, or expert in materials, refrain from expressing an opinion as to the credibility of the representations of the management regarding quantity and condition.

2. In those industries in which it is customary to take physical inventories no instances have been observed where it is not practicable and reasonable to be present at the inventory taking and by suitable observation and inquiry formulate an opinion as to the effectiveness of the methods of inventory taking, although it may not always be feasible to supplement such observation and inquiry by tests of quantities. The extent of the accountant's contact with the inventory will be governed by the effectiveness of the internal check as applied to the taking of physical inventory.

3. In those industries in which the inventory amounts are customarily determined from book records adjusted to facts upon their determination, it is usually feasible for the accountant to examine into the effectiveness of the methods which provide for current adjustment, to make some corroborative tests and in conjunction with related operating factors and pertinent inquiry to formulate an opinion as to the general integrity of the inventory records.

The following excerpts from "Extensions of Auditing Procedure," October, 1939, are enlightening:

INVENTORIES

Added steps may well be taken to give greater assurance with regard to inventories. The extent of such additional procedures will necessarily vary with the circumstances, because the independent auditor

is justified in giving consideration to the effectiveness of the internal check and control as applied not only to book records, but also to the procedure of taking physical inventories. But, however extensive these may be, the training and experience of an independent certified public accountant do not qualify him as a general appraiser, valuer, or expert in materials. The public should understand that, while he can in his capacity as an auditor undertake additional procedures as to inventories, such procedures do not invest his opinion with a degree of authority which he does not claim for it or impose upon him a measure of responsibility which the nature of his work does not justify. Such procedures are only for the purpose of satisfying himself as to the credibility of the representations of the management regarding quantity and condition.

Taken in consideration with the foregoing discussion of auditing procedures, the following recommendations are made concerning inventories:

(*A*) That hereafter, where the independent certified public accountant intends to report over his signature on the financial statements of a concern in which inventories are a material factor, it should be generally accepted auditing procedure that, in addition to making auditing tests and checks of the inventory accounts and records, he shall, wherever practicable and reasonable, be present, either in person or by his representatives, at the inventory taking and by suitable observation and inquiry satisfy himself as to the effectiveness of the methods of inventory taking and as to the measure of reliance which may be placed upon the client's representations as to inventories and upon the records thereof. In this connection the independent certified public accountant may require physical tests of inventories to be made under his observation.

In cases where the inventory is determined solely by means of a physical inventory at the end of the accounting period (or at a date prior or subsequent thereto but within a reasonable time thereof, with adequate records supporting the interim changes), it will ordinarily be necessary for the foregoing procedures to be followed at that time.

In cases where the concern maintains well-kept and controlled perpetual inventory records supported by (1) a complete physical inventory at a date not coincident with the balance-sheet date, or (2) physical inventories of individual items taken from time to time so that the quantity of each item on hand is compared with the inventory record for that item at least once in each year, it will be satisfactory to undertake the procedure outlined at any interim date or dates selected by the auditor, his purpose being to satisfy himself as to the credibility of the perpetual inventory records and whether they may be relied upon to support the inventory totals as shown on the balance-sheet.

(*B*) That hereafter, in the case of inventories which in the ordinary course of business are in the hands of public warehouses or other outside custodians, direct confirmation in writing from such custodians is acceptable procedure; except that, where the amount involved repre-

sents a significant proportion of the current assets or of the total assets of a concern, the independent certified public accountant shall make supplementary inquiries.

It should be clearly understood that in undertaking these auditing procedures regarding inventories, the independent certified public accountant does so for the purpose of satisfying himself as to the credibility of the representations of the management regarding quantity and condition and does not hold himself out as a general appraiser, valuer, or expert in materials.

The general adoption of such added procedures regarding inventories may necessitate procedural changes on the part of clients. So many corporations close their books upon a calendar-year basis that it is doubtful whether the profession as at present organized can undertake the additional work adequately and satisfactorily on the last day of each year. Many corporations do not have adequate perpetual inventory records and greater use of them should be encouraged.

The extension of procedures regarding inventories would be greatly facilitated if each concern adopted its natural business year instead of the calendar year as its fiscal year, and introduced continuous well-kept perpetual inventory records.

The proposed changes will take time to bring about, and in the meantime the profession may well be faced with the necessity of submitting qualified reports in those cases in which it has been impracticable to carry out the added procedures.

When it is believed that the tags, tickets, cards, or other means used to record the count in the beginning have been satisfactorily made out, it is necessary to ascertain whether the quantities have been accurately accumulated on the original stock sheets and transferred without error to the final inventory summary sheets. Sufficient arithmetical tests should be made of amounts transferred and footed in order to satisfy the auditor as to the absence of clerical blunders. Inventory records should be signed or initialed by the persons who made them; it helps fix responsibility, which tends to make people more careful and their work more reliable.

In those businesses where adequate book inventory records are maintained, the auditor must participate in the physical check of quantities against the book records. Since it is possible to make a physical count of a few of the items from time to time, this work may be done throughout the year, and the public accountant can give it special attention in periods when he has less to do. Ordinarily items should have their physical count compared with book records every 3 or 4 months. When there is a high degree of correlation, perhaps within 1 per cent, the auditor may believe

that the book inventory records are reasonably worthy of his reliance. If the two do not substantially agree, he may either be forced to qualify his certificate or report or to demand that inventory quantities as of the balance sheet date be substantiated by a complete physical count in which he has a hand. Of course, all items in the inventory should already have been charged to some purchase account and suitably credited to Cash or proper liability account. It is possible that invoices have been postdated to allow a longer period of credit; if, however, the goods belong in the inventory, they must be regarded as having been already purchased.

Goods in Process and Finished Goods.—The quantities of goods in process and finished goods included in the inventories of a factory can usually be obtained from a good cost system if it is being properly administered. The auditor must understand cost accounting sufficiently so that he can pass judgment upon the system and the way it is being kept. If the system is not controlled by the general financial books, it is likely to be less reliable. Physical test checks should be made, however, of quantities of some of the goods in process and finished goods, no matter how reliable the cost system appears to be. If the reliability of the system is seriously questioned, the test checks may well be more extensive, and particular attention should be devoted to seeing that goods sold in the month preceding the balance sheet date are not in the inventory as revealed by the book records. As to the goods in process, accurate quantities must be ascertained for the product at the various stages of completion.

Goods on Consignment.—When the auditor is working on inventories, he must make sure as far as possible that all of them actually belong to the client. He must look for evidence as to whether goods are ever received from others on consignment; in that event, particular care must be used that no such materials are included in the assets of the business. When consigned goods are of such large proportions as to be significant, mention of them may be made in a footnote on the balance sheet. If some of the inventory on hand belongs to others and has been set aside for them, delivery merely awaiting the convenience of the owners, these goods should also be excluded. Goods owned by the concern and out on consignment should be tested by the records and by confirmation.

Goods in Transit.—Public accountants customarily include goods in transit with the inventory figures. When this is done,

such goods must be included in purchases also, and, of course, the cost will normally appear among the accounts payable. If there is a possibility that goods have been received under purchase contracts, billings to come later, the inclusion of them in inventory likewise requires that they be treated as purchases, and confirmations of quantities delivered should be received from the seller; otherwise an overstatement of profit would result, as well as an overoptimistic current ratio on the balance sheet.

Miscellaneous Items.—There is a possibility that some items of the nature of machinery or equipment may have been charged to the ordinary purchase and inventory accounts, but they should not be included in these categories.

Having considered all the above matters concerning inventory quantities, it is well for the public accountant to ask himself whether they are reasonable with reference to current purchases and sales. Confirmation of quantities should be obtained from one or more responsible officials as part of an inventory certificate. A committee of the American Institute of Accountants has recently (see *The Journal of Accountancy* for March, 1941) presented the following skeleton form of representation covering inventories and notes thereon:

WRITTEN REPRESENTATION COVERING INVENTORIES

Blank Company,
Certified Public Accountants,
Blank Street,
City

Dear Sirs:

In connection with your examination of the accounts of (blank company) and more particularly in connection with your examination of the (blank company or department) as at (blank date), we hereby make the following statements and representations concerning inventories of (blank company):

A. Quantities and Amounts
B. Title and Ownership
C. Prices and Calculations
D. Commitments
E. Condition

The foregoing constitutes a fair statement of quantities and valuations of the respective inventories as at (date as of which

audit is made) to the best of the knowledge and belief of the undersigned.

(Signature)

(Date signed)

NOTES ON WRITTEN INVENTORY REPRESENTATION

General.—The representation may be prepared either for one or several classifications of material, as raw materials, goods in process, finished goods, supplies, and may be subdivided if convenient, and if the amount is sufficiently important, into separate representations for the inventories in particular departments or plants. It is preferable for the representation to specify the particular location of the inventory by plant or warehouse.

The officials and employees who sign the representation are usually asked to state that the inventory was taken under their direction. In the case of junior executives, this would mean under their direct supervision. In the case of executive officials it would mean under their general instructions.

The items listed for attention and consideration under the various headings shown in the skeleton form for inventory representation are all reported to have been used by some of the fifty-two firms who have cooperated with the subcommittee in making this inquiry. There are some items common to the representations of practically all firms reporting, while others are included in the representations of a much smaller number of firms depending, presumably, in many cases on the nature of the practice or the particular trades or industries in which a majority of a firm's clients may operate. The list of items to be considered under each heading may, therefore, be regarded as a maximum rather than a minimum and it is quite likely that there will be few cases in which every item will be applicable.

A. Quantities and Amounts.—The items falling under this heading are:

1. A classification of the inventory as between, say, raw materials, goods in process, finished goods, supplies, etc.;
2. A statement that the inventories covered by the representation were taken under the direction of those signing the representation;
3. A statement that the inventories were taken in accordance with inventory instructions, copies of which had been delivered to the auditors;
4. A statement that the quantities were correct and were determined by actual count, weight or measurement under the supervision of an official of the company on a specific date;
5. A statement that the books have been adjusted to the physical inventory, that all adjustments between book values and physical inventories have been made, that any adjustments necessary because inventories were taken at a date different

from the close of the fiscal year have been made and that the books have been closed on the bases of such physical inventories;

6. If a physical inventory was not taken, a statement that an adequate perpetual-inventory system is maintained and the foregoing quantities and amounts are in agreement therewith;
7. Where perpetual inventories are relied on, a statement as to the frequency and coverage of physical tests;
8. Where there are methods of inventory taking in use which are generally considered to be physical but which are, to a certain extent, calculated or based on records (as, for instance, where the determination of the content of tanks of chemicals, fuel oil, or similar material has been made by physical or chemical tests or the calculation of a pile of coal, stone, or similar material by an engineering calculation) a statement to that effect.

B. Title and Ownership.—Under this heading there are included in the various forms of written representations submitted by the cooperating firms statements that the inventory as shown by the books adjusted as described above:

1. Is the unencumbered property of the company and includes no material held on consignment from others, except:
2. Has not been pledged as collateral, except:
3. Includes no items billed by the company prior to (date as of which audit is made);
4. Includes no items not paid for or for which the liability has not been taken into account;
5. Is subject to no liens or other encumbrances for duties, taxes, or similar items which have not been taken into account with the specified exceptions.

C. Prices and Calculations.—This caption includes statements that:

1. The inventory is priced at the lower of cost or market with a general statement of the basis on which this cost is determined, as first-in, first-out, average, last-in, first-out, or the like (where any method representing an unusual or not generally recognized practice is used, the form sometimes requests this to be described fully);
2. The basis of pricing and method of computation is the same as used for the previous period, and unless definite instructions have been given to use different methods or principles in pricing the inventory, a statement that the inventory basis is the same as that used for the previous period. The company's own internal check and the independent audit should disclose variations from the method prescribed which were made in error, which this item is presumably not intended to cover.

3. The method described does not place a value on the inventory in excess of cost.
4. The prices used for materials are not in excess of the replacement cost at the date as of which the audit is made;
5. The replacement cost of inventory has not materially declined between the date as of which the audit is made and the date on which the representation is signed;
6. If the inventory is valued at market, where market is below cost, the market price is determined by some recognized method which is to be described.

D. Commitments.—Where this item is covered by inventory representations, it is generally provided that statements should be made that:

1. No sales commitments exist below inventory prices;
2. No purchase commitments exist at prices in excess of current market as of the date of the balance-sheet except:
3. No purchase or sales commitments exist in excess of normal requirements, with specified exceptions.

E. Condition.—The forms submitted included statements to the effect that no slow-moving, obsolete, damaged, depreciated, or deteriorated materials or merchandise are included in the inventory at prices in excess of net realizable value.

Signature.—The number of signatures and the position and title of those signing the representations for the client company vary greatly in the different forms of inventory representations submitted. In many cases, a single signature or general approval of an executive official only is asked for, while in others, separate signatures of junior executives responsible respectively for quantities, values and prices, and condition are required in addition. In general, where officials or employees sign separately for quantities, values and prices, and condition, it is contemplated that they do so as a matter of direct personal knowledge.

The signature for general approval may or may not indicate direct personal knowledge. This signature may be that of a general executive who signs merely on the basis that he has given instructions to subordinates on whom he relies and who, he assumes, are carrying out his instructions and their duties correctly. In a smaller concern the signature for general approval will probably indicate greater specific knowledge on the part of the official signing than in a larger organization.

QUALITY AND CONDITION

After quantities have been determined, it becomes necessary to endeavor to ascertain whether the management has valued the inventory with due regard for quality and condition. Although

the auditor must rely to a large extent upon representations from responsible officials and employees, he must do what he can to build firsthand estimates. Actual inspection of the goods through participation in their count may be very helpful in this respect. Consideration of changes in the type of product manufactured and sold may also be of assistance. The auditor should also contemplate whether the management is of the sort that would tend to weed out and sell at a sacrifice, if necessary, everything which would not move in the normal course of business, or whether it would be inclined to make an accumulation of older goods not salable through ordinary channels. In a few cases engineers and other technical experts have been called in to give their advice as to various aspects of the inventory.

Stock which is no longer being manufactured, although still salable, may not be as valuable as previously. In that case it will have to be treated similarly to damaged, defective, or shopworn stock. On the other hand, if it consists of such things as repair parts for which sales are to be expected, it may require no special write-down.

Since the auditor is particularly at the mercy of responsible officials when dealing with goods that are not of standard quality or condition, he should note carefully their attitude when they are asked to make statements concerning such stock over their own signatures in the inventory certificate.

BASIS OF PRICING

As current assets, inventories should usually appear on balance sheets at cost or market, whichever is lower. This basis indicates the minimum net return which should be available to meet current obligations. When other bases are used, adequate mention should be made of the fact so that the reader may draw proper conclusions. In the computation of profits, it is important that the inventories be stated on the same basis at the beginning as at the end of the period. Otherwise, the approximate effect of the change in basis upon the showing of profits should be revealed. The quantities of good salable stock should ordinarily have cost and market unit prices applied individually, in order that the inventory may be expressed at the lower figure.

Cost.—Cost seems at first blush to be a very definite thing, but, as a matter of fact, it may be difficult to determine in many cases,

even though invoices are available for checking. When the same things have been acquired in varying quantities at different times throughout the period, it may be impossible to attribute the actual cost to the items on hand at inventory date. Then an assumption must be made as to whether the first or last goods bought are still in the inventory or an average cost may be used. What is acceptable depends in large measure upon trade custom. Cost of manufactured goods may be obtained from the cost system or from more or less dependable estimates.

In order to determine the reliance to be placed on the figures provided by the cost system for goods in process and finished goods, the auditor must study and test the system in force until he is satisfied. He must be sure that such figures end with factory costs; that no selling, delivery, or general administrative expenses are included therein. Particular attention should be given to the suitableness of the method used in allocating factory overhead. Although interest is occasionally included as a cost, for purposes of inventory computations the auditor should be sure that it is rigorously excluded. The auditor must also see that no padding of inventory figures occurs through the inclusion of interdepartment or intercompany profits or through charging actual overhead in periods of low production rather than using an overhead rate based on normal production.

Amounts charged to inventory for buying expenses, duties, freight in, insurance, etc., whether in a manufacturing or a merchandising business, may be perfectly reasonable, but the auditor is under an obligation to make an adequate investigation of them. Cost prices should also be reduced for trade discounts, which are normally to be considered any discount in excess of, say, 2 per cent. Even cash discounts of 2 per cent should be deducted from billed prices to arrive at true cost, but since the amount is relatively small, it is considered satisfactory to overlook it if it is the custom of the trade or business to look upon cash discounts taken as other income.

The Retail Inventory Method.—Since the retail inventory method is now in operation in various types of retail stores, the public accountant must understand it in order to find the sound cost of the inventories in such establishments. The goods in stock carry on their tags the retail price. Part of this price is cost and the balance is the markup. It is necessary to be able to ascertain

the accumulated percentage of markup in order to subtract it from the selling price and find the sound cost, which reflects market conditions in that it makes allowances for markdowns caused by market conditions.

Stores using the system add to their beginning inventory at cost their purchases at cost (including transportation charges) and add to their beginning inventory at retail their purchases at retail and any additional markups taken. When from this retail total the cost of the same items is subtracted, the accumulated markup is found. The percentage of this markup to the total retail price of inventory plus purchases is ascertained and is known as the cumulative or accumulated markup percentage. It is to be noted that this percentage is calculated before either the total retail price or the total markup has been reduced by markdowns. As may be noted in the next paragraph, markdowns are treated in a manner similar to net sales.

If net sales, plus markdowns (minus markdown cancellations), plus employee discounts, plus known inventory shrinkage are subtracted at retail from the total retail figure, the ending book inventory figure at retail is found and, of course, should agree with the inventory in stock. If the accumulated markup percentage is 40 per cent, then by subtracting 40 per cent from the ending inventory figure at retail the ending inventory figure at sound cost may be derived. Or, since 60 per cent is the complement, which together with the 40 per cent markup accounts for 100 per cent of the retail price, the multiplication of the ending inventory figure at retail by .60 will produce the sound cost of the ending inventory, provided it agrees with the actual goods in stock.

It is again to be emphasized that this cost complement is the complementary percentage of the cumulative markup (before markdowns) and not of the maintained markup (after markdowns). Otherwise the retail inventory method will never reflect any merchandise depreciation.

Since there is a question about the presence of the goods, the stores make a count of the goods on hand on the inventory date, listing them at retail, and apply the accumulated markup percentage complement directly to this total in order to derive the sound cost of the inventory. Inventories for each department are found separately. The sound cost appears to reflect the

lower of cost or market satisfactorily for most purposes and is a useful mercantile concept.

Market.—Ascertainment of proper market prices may be either relatively easy or difficult. In some cases printed quotations may be available. Then it becomes a question of whether they are applicable to the quantities on hand. In other cases quotations may be obtained from suppliers, or market prices may be approximated from recent invoices. Cost of replacement, *i.e.*, current costs of material, labor, and burden, under conditions existing as of the balance sheet date ordinarily will indicate market prices for goods in process and finished goods manufactured. Market prices may be tested by comparison with selling prices for the same goods at the balance sheet date, shipping and selling expenses and allowance for a normal profit being deducted to indicate the market price which reasonably could have been recovered in event of sale.

Clerical Accuracy.—If the auditor is satisfied with the pricing of the inventory, he must give attention to the accuracy of the clerical work involved. He must make sufficient tests to see that not only have the cost or market prices been properly applied but also that extensions, forwardings, and totals have been properly made. The persons responsible for determining these inventory figures and making calculations from them should be required to sign or initial the papers upon which their work appears. They should also be required to sign the appropriate portion of the inventory certificate received by the auditor from responsible officials.

Goods Not Readily Salable.—In the case of goods not of standard quality or condition or goods which for some other reason are not readily salable in the normal course of business, special care must be exercised to see that they are not overpriced. In such instances, costs will ordinarily not be of great significance. Expected selling prices, reduced by estimated expenses of effecting the sales and also reduced by a normal profit for the period which actually makes the sales, should generally indicate a fair market value to be given to these goods. It should be remembered that stock otherwise perfectly good may require a write-down if the quantity is excessive in view of the current needs of the business. Such goods may in some cases be so excessive in quantity that a large part of them may not be disposable for years

in the usual course of business; it is highly questionable whether or not they should be buried among the current assets without comment.

MISCELLANEOUS INVESTIGATION

When the auditor has, by the above methods, arrived at satisfactory conclusions as to quantities of and prices for the inventory, he should ask himself whether or not in view of all the facts his results seem reasonable. His experience with other companies and his knowledge of inventories carried by the business under audit in relation to its purchases and sales in the past may help him reach satisfactory conclusions. Important changes in figures for turnover should make him suspicious. As a general over-all check, he might apply the gross profit test if he is dealing with a business in which the average percentage of gross profit has been fairly uniform for a period of years. If he subtracts this derived gross profit figure from the known sales figure and thus arrives at a figure close to the real cost of sales, he can subtract the latter from the total for beginning inventory and purchases, which represents the cost of all goods handled, and thus approximate the inventory cost; this final figure can, in turn, be checked with what the auditor previously thought it was. In case of significant discrepancy not brought about by change in the markup of goods involving a new gross profit rate, the auditor may well doubt whether he has as yet secured reliable inventory figures. If he is still satisfied that he can rely upon his inventory results, he must, nevertheless, take appropriate action to ascertain whether any of the stock is hypothecated, in which event the fact should be mentioned upon the balance sheet so that the reader may know how much is available to meet unsecured obligations.

BALANCE SHEET VERSUS DETAILED AUDIT

The procedure indicated above should provide a reasonable idea of what the auditor is usually obligated to do concerning inventories in the process of a balance sheet audit. In a detailed audit, he will have to test purchases, the method of storekeeping, and sales, sufficiently to be satisfied that what is on hand is what should be there. Detailed checks in these areas may expose theft or carelessness. Goods shown to have been received by the records can be checked against stores records, and shipping

records can be tested against requisitions from stores. Attention may also be given in a detailed audit to the arithmetical accuracy of figuring used in entering, adding, and subtracting on the stock cards.

QUESTIONS

1. Why does the audit of inventories require special attention from the public accountant?
2. What should be the first step in an inventory audit?
3. How may the clerical accuracy of the inventory count be established?
4. What recent expansion of inventory auditing has been promulgated by the American Institute of Accountants?
5. What have been the experiences of practicing accountants with extensions of inventory auditing procedures?
6. Why should inventory records be signed by the persons who made them?
7. What should the auditor do about checking book inventory records with physical quantities?
8. How may the goods in process and finished goods inventories be checked adequately?
9. How should goods on consignment be verified?
10. How should goods in transit be accounted for?
11. How may the auditor pass judgment on the quality and condition of the inventories?
12. Discuss the determination of cost for inventories.
13. Describe the retail inventory method.
14. How may market prices be determined and tested?
15. Of what value is the securing of an inventory certificate from responsible officials?
16. What factors should be considered in the pricing of goods not readily salable?
17. What is the gross profit test and how may it be used in auditing inventories?
18. What procedure should the auditor follow in a detailed inventory audit?

CHAPTER VIII

AUDIT OF FIXED ASSETS

Fixed assets include land, buildings, and equipment, which are used in the operation of the business rather than sold outright in the expectation of a profit. In a sense, fixed assets are sold piecemeal when the ordinary merchandise or product of the business is sold; the sale price should include a return for the fixed assets which have been exhausted. Use of the foregoing procedure is the only way in which capital invested in the business can be maintained from the point of view of dollars, and unless a business is maintaining its invested dollar capital, it can hardly be said to be earning a return upon its investment.

BALANCE SHEET PRESENTATION

Since the money invested in fixed assets is more or less frozen and is released only as the business functions throughout the years, these particular assets are not of prime importance from the point of view of meeting current obligations in the ordinary course of business; it is the custom, therefore, to show them on balance sheets at their historical cost figures with an allowance for the portion of these costs which the company has attempted to recover through sales. The net effect is to show the fixed assets at the amounts which still must be recovered from them to maintain the dollar capital intact. For most purposes this is satisfactory; an appraisal can be made if it is necessary to have figures approximating market for such purposes as the issuance of bonds or the sale of the fixed assets. Frequently balance sheets are supposed to reveal more than can reasonably be expected; if they reflect present values for fixed assets, the costs to be recovered from operations before the emergence of a profit may be lost from sight and the reported profit may have little relation to the facts. In general, adherence to historical cost, with deductions of fair reserves for depreciation and depletion, in the body of the balance sheet is to be preferred. Market values can, if desirable in a

given case, be indicated by an attached parenthetical note or in a footnote. Since market values of fixed assets are the estimates of some person or persons, it is advisable to give the name of the appraiser and the date of his appraisal in order that the reader may make his own conclusions as to the validity of the estimates.

On the balance sheet the several sorts of fixed assets should ordinarily be shown in sufficient detail so that the reader may make intelligent use of the information. Those not used in the operations of the business should be separately stated. Valuation reserves should be deducted from the assets to which they apply rather than put on the liability side. It is sometimes helpful for the reader to be furnished detailed analyses of changes in the reserves.

Fixed assets may well include property to which the business under audit does not have technical legal title. Legal title to mortgaged property may, for example, be in the mortgagee. Since the mortgagor has generally the right to use the property, practice dictates that it be shown as a fixed asset of the mortgagor and that the mortgage be included among the liabilities. By way of further illustration, automobiles, machinery, or other equipment may be purchased under a conditional sale agreement, legal title remaining with the seller until paid for. Since the use of the thing bought belongs to the buyer, it is an asset for his balance sheet, and amounts to be paid are liabilities requiring fitting disclosure.

The auditor's chief responsibilities, then, are (1) to ascertain whether the fixed assets are shown on the balance sheet at cost, (2) to determine whether the reserves deducted on the balance sheet from such costs are fair and reasonable, and (3) to determine whether the charge to the period on the operating statement is justified in view of their part in the period's operations.

INITIAL STAGES

It is fortunate that the fixed assets are often regarded by the reader as being of relatively minor importance, as just a bit of ancient history, in the average balance sheet, since frequently the auditor would have an overwhelming task to do the thorough job that would be required if they were of pressing significance. Of course, the fixed asset problems of public utilities are far different and more important than those in the usual industrial enterprise.

During the past few years much improvement has been introduced into fixed asset record-keeping, but poor and unreliable records inherited from the past are still found in many businesses. Sometimes the old records are untrustworthy, whereas those of the last few years are worthy of confidence. When the impossibility of obtaining authentic figures with reasonable labor makes it necessary to accept whatever figures are on the books, the public accountant must protect himself by an appropriate revelation of the facts.

If a business has been audited year by year by reputable independent accountants who have carried along cost and reserve figures, the auditor called upon to make an audit for a given year may well be able to begin safely with the figures with which the former auditors ended. He may, accordingly, confine his examination to the transactions of the year which he is auditing. However, in case he has no such reliable figures upon which to base his work, he must consider to what extent fixed asset records from the inception of the business must be investigated. Here again his study of the bookkeeping system, the way and manner in which it is and was kept, and the internal check, together with the history of the business and its management, may serve to show him what he is reasonably bound to do. Perhaps a detailed check of every transaction would be out of the question, either because of the volume of the work or the unavailability of necessary records. In that case a frank statement to the effect that unaudited book records have been accepted as a basis for the audit of the present year's figures would be the wisest procedure. The auditor's study of the situation might, however, lead him to feel that book figures could be accepted as reasonably authentic if a few of the larger items were subjected to thorough test. The ability to produce satisfying documents and records as to these could do much toward making him feel that it was proper to accept all the book figures.

The auditor is an independent public accountant capable of expressing opinions as to the books and records of a business; he is not a lawyer, an appraiser, or an insurer. His job is to be reasonably satisfied as to the facts from a study of books, records, and persons and from an inspection of physical assets. When he is investigating the acquisition of fixed assets by a business, he must consider deeds, mortgages, insurance, correspondence with attorneys, agreements and contracts, memoranda, and everything else

that will throw necessary light on the facts, but he passes upon them merely as an accountant and in no other capacity.

PROCEDURE

When the auditor is satisfied as to the bases to be used for the audit of the various fixed assets for the year in question, he should draw up schedules on working papers summarizing for each fixed asset the balances at the beginning of the period, book additions and deductions, and the final balances at the end of the period. These final balances are subject to the auditor's adjustments to bring them to the figures which the auditor believes he may certify. Having satisfied himself as to the beginning balances, he still has left the job of making sufficient investigation of the period's additions and deductions. If he has faith in the records as they stand, he may be content to check a few of the larger items as a sample and base his conclusions on this test; this would be the usual procedure in a balance sheet audit. In a detailed audit, by way of contrast, a much more extensive test would probably have to be made.

The totals of the balances on the schedules for the beginning of the period should agree with the total fixed assets on the balance sheet at that date and also with the figures on the ledger. The ending schedule balances should be in agreement with the figures on the balance sheet on which the auditor is to report, and the ledger figures should be adjusted to agree with them if there is any discrepancy. It is helpful to note whether any accounts have been opened and closed during the period. They may not have any effect on the final balance sheet figures, but they may be enlightening as to the income of the period.

The next step is to consider the type of test to be applied to additions and deductions of the period. Additions should be proper capital charges; an examination of authorizations for expenditures during the period may help to decide whether they are. If costs of additions exceed authorizations, light may be thrown upon the care and efficiency of the company's management and system, and the auditor may be guided in deciding what investigation to undertake. If the authorizations appear to have been carefully prepared, show definitely the accounts to be charged, bear approval of one or more responsible officials, and describe satisfactorily the nature of the work, the auditor will

doubtless feel that they afford him substantial help. In the event that authorizations are unsatisfactory and lacking in detail, the auditor will have to make such further investigation as seems reasonable to him. He may have to view the work done, question appropriate personnel, and read pertinent material to determine whether the expenditure as checked with the cash records was for a repair which should have been charged to operations, for a replacement with which a reserve should have been debited, or for a real addition to the fixed assets in the amount specified.

If the business has constructed plant, machinery, or other equipment for itself during the period under audit, special care should be exerted to ascertain whether labor and material charges have been fairly applied. In the event that the construction is sizable, this may entail a fairly thorough investigation of payroll distribution methods and practice in handling stores. Burden or overhead is generally worthy of careful attention; as applied to construction, it may require special thought. Only that part which contributes to construction should be charged to it; for example, the time that officials and their staffs devote to it. Overhead must not be loaded on construction to such an extent that operations do not bear a normal charge; to do so will make the period's figures incomparable with those of other operating periods.

Although as a general rule interest is not a cost to be capitalized, it is in some cases considered proper to charge it to capital during the time of construction. Otherwise the total cost to be recovered through operations would not be disclosed by the book records. Industries such as utilities, whose rates are theoretically based on the service they offer to the public, often should include interest in the original cost.

On the balance sheet date construction may be in progress, and materials may be on hand which are to be used for construction of fixed assets. Since these are not intended for sale in the ordinary course of business, they should not be included in the inventories but should be shown among the fixed assets on the balance sheet.

When construction is being done for the business by outside contractors, contracts, invoices, estimates, and all other evidence should be examined in order to determine the capital charges and liability for payments which should be revealed on the balance sheet. Important commitments for future payments which have

a substantial bearing upon the financial condition of the business may require mention in a footnote to the balance sheet.

Purchases of real estate require attention from many angles. Authorization, cost, correspondence with sellers and attorneys, deeds, title policies, and insurance policies all need careful study. Absence of insurance policies, they being in the hands of mortgagees, may be the only clue to a mortgage upon the property, although a careful survey of the records of cash receipts might in other instances reveal a mortgage. The auditor as such does not search the public records to verify title or encumbrances; that is the work of a lawyer. Ordinarily the auditor does not ask that the legal titles be searched in connection with his work; he may, if it seems advisable, secure permission from proper officials to request information from the attorneys for the business. The fact that a deed has or has not been recorded may or may not have important legal significance, but an unrecorded deed is evidence to the public accountant of either carelessness on the part of some individual or the worthlessness of the title.

Leases ordinarily should not appear among the assets of a business unless they have been bought. They should be read carefully by the public accountant, however. Not only must he consider the amount at which they are to be shown on the balance sheet and operating statement, but also he must see to it that any improvements to such leasehold property are being amortized so that they will be entirely written off by the time that the lease expires, unless it is expressly provided that they are to remain the property of the lessee. If the lease contains an option to renew, the accountant should exercise good business judgment to determine the probable effective life of the lease.

Deductions during the period should also receive careful attention. They are often, sad to say, handled in a careless manner. Fixed assets may be abandoned without any record of the fact being made. Perhaps the only clue for the auditor as to things of this sort may be a chance remark as to change in product. Then again perusal of detailed sales statistics or the prideful exhibition of new fixed assets might make the auditor suspicious as to abandonments. The independent public accountant must note that all property abandoned has been properly cleared from asset and reserve accounts and that any loss or gain involved has been taken.

Investigation of like manner should be made of property sold, destroyed by fire, or for any other reason no longer in service. Such properties should generally no longer appear as assets and there should therefore be no offset reserve against them; when they are no longer serviceable, any net amounts in the accounts should either be charged off entirely or reduced to scrap value or to amounts recoverable through insurance. Property not being used at the moment should be subjected to scrutiny to determine whether it should be shown as an asset and whether suitable charges to operations, to surplus, or to both are being made.

The reader of the balance sheet normally expects that fixed assets are suitably covered by insurance. Investigation of insurance policies is necessary for the auditor to compute deferred charges and usually helps the auditor in settling in his mind the facts concerning the fixed assets. He should make note of the fact if any are not adequately covered or are insured beyond reason. His experience is such that he may be able to offer suggestions in connection with insurance which, when taken up with a competent insurance expert, will lead to substantial premium savings for the business being audited.

Fire insurance policies should be inspected to see whether they contain coinsurance clauses. When they exist, particular care must be used to note whether there is adequate insurance coverage, especially in case of partial losses. In the event of a total loss the face amount of the policy may be collected, but the full amount of a partial loss cannot be recovered unless the business carries as much insurance as is demanded by the coinsurance clause. For insurance purposes the value used as a basis is frequently the cost of replacement. Suppose in a given case this is \$10,000. If the insurance policy has an 80 per cent coinsurance clause, \$8,000 insurance must be carried to collect fully on partial losses up to this amount. Of course, the face of the policy is the limit which may be collected whether loss is full or partial. If in spite of the facts given the business carries only \$6,000 of insurance, it can collect only $\frac{\$6,000}{\$8,000} \times 100$, or 75 per cent of the partial loss. Likewise, if it carries only \$4,000 of insurance, it can recover only half of a partial loss and is therefore coinsurer with the insurance company to the extent of 50 per cent.

While the public accountant is auditing the fixed assets, he should give attention to the reserves for depreciation, retirement, or depletion connected therewith. He must determine whether in his judgment the method used to accumulate them is satisfactory and whether charges to earnings connected therewith are reasonable. They must be considered together with charges for repairs and replacements. Tests should be made of the charges against the reserves.

In many cases composite assets are purchased for cash, stock, or other consideration. The auditor must try to determine from a study of contracts, deeds, mortgages, and resolutions of directors, from discussion with responsible officials, and from all other possible means, whether suitable breakdown has been made on the records of the total consideration among the various fixed and other assets acquired. Too often in the past have fixed asset accounts been charged with what was given for intangibles. Attention should be given to charges and credits made to surplus in connection with transactions of this type from the point of view of balance sheet presentation and fair and comparable charges against earnings over the years.

In the event that the condition of the records is such that the auditor is not satisfied that the figure for fixed assets is reasonable, that reserves for depreciation and depletion are adequate, and that current operations are being charged a fair amount for their use, he must reveal the facts in his certificate or report.

Until fixed asset records are more properly kept in general, in spite of all that the public accountant may do to perform his work satisfactorily, he may feel that he needs the added assurance of a certificate from responsible officials concerning fixed assets. They should be asked to state in writing that in their opinion the figures for the beginning of the period are accurate, additions are proper, deductions have been recorded to reflect the facts, the plant is being efficiently maintained, depreciation and depletion provisions are sufficient, and that no important policy changes have taken place without their revelation to the auditor.

QUESTIONS

1. How are fixed assets generally shown on the balance sheet?

2. What significance should be attached to the market values of fixed assets?

3. How should mortgaged property be shown on the balance sheet?

4. What are the auditor's chief responsibilities in connection with fixed assets?

5. What should the auditor do about investigating fixed asset records from the inception of the business?

6. What should the auditor do when investigating the acquisition of fixed assets by a business?

7. Describe the procedure to be followed in the audit of the various fixed assets for the year.

8. What type of tests should be applied to additions and deductions of the period?

9. How should plant or machinery constructed by the business for itself be audited?

10. Should interest expense be capitalized?

11. Why do purchases of real estate require much attention from the auditor?

12. How should leases be accounted for?

13. How should the auditor investigate deductions from fixed assets during the period?

14. What is the significance of the coinsurance clause in fire insurance policies?

15. What type of investigation is necessary in auditing reserves for depreciation and depletion?

16. Describe the procedure in auditing composite assets purchased for cash, stock, or other consideration.

17. When is a certificate from officials concerning fixed assets necessary?

CHAPTER IX

AUDIT OF OTHER ASSETS

The principal types of assets to be covered in this chapter are (1) prepaid expenses and deferred charges, (2) intangibles, and (3) contingent assets. Although these assets may in themselves be of relatively minor importance on a typical balance sheet, careful audit procedure applied to them may be rewarding in that it may furnish valuable clues as to other related assets and liabilities as well as income and expense connected therewith.

PREPAID EXPENSES AND DEFERRED CHARGES

A distinction is sometimes made between prepaid expenses and deferred charges. Prepaid expenses represent advance payments for services to be rendered in the future. This future period is generally quite definite as to length. The auditor should see that the expense is fairly prorated over the time which receives the benefit of the service, which is usually a relatively simple matter; the unconsumed portion of the prepaid expense is, naturally, an asset.

Deferred charges, on the other hand, frequently represent services already rendered whose benefits are expected to be felt for a more or less indeterminate future period. In this case the auditor must pass judgment on whether or not (1) it is satisfactory to defer a given amount and show it as an asset on the balance sheet and (2) the various fiscal periods are being charged fairly for the benefits from the services accruing to them. The latter is usually more difficult than in the handling of prepaid expenses.

Prepaid Expenses.—As examples of prepaid expenses, mention may be made of rent; taxes; interest, discount, and related expense; salaries and commissions; insurance; advertising; and royalties for which payment has been made prior to the rendering of the service. The auditor usually prepares a separate schedule for each item, showing the composition of the beginning balance, the details as to additions and deductions during the period, and

the composition of the ending book balance, together with adjustments thought to be necessary to make the latter accord with the facts of the situation, thus resulting in figures meriting his sanction. Sometimes he works directly from book figures, and in other cases he has the assistance of schedules and computations prepared by the client's staff. He should try to find documentary support for his conclusions: rent can be verified from leases and receipts; taxes from tax bills; interest, discount, and related expense from notes, indentures, agreements, and confirmations; salaries and commissions from canceled checks, agreements, receipts, and confirmations; advertising from contracts and agreements; insurance from policies and confirmations; and royalties from agreements. Talking these over with officers of the business under audit may be helpful. In most cases it should be relatively simple to determine the portion of the services paid for but not received, and hence an asset, and the part received by the period and chargeable to it. Some argue that prepaid expenses should be included with the current assets on the balance sheet, but it appears to be better practice generally to include them with deferred charges toward the bottom of the balance sheet.

In some cases even prepaid expenses call for the exercise of some judgment. Suppose a fire policy is bought covering 3 or 5 years' protection. Such a procedure is a matter of economy; a 3-year policy usually costs only two and one-half times the annual rate, whereas a 5-year policy can generally be obtained for only four times the 1-year premium. The policy ordinarily may be canceled and a return premium received, but the amount returned is less than pro rata, being computed at so-called "short rates." Since the policy is supposed to be acquired by a going business, not for the prime purpose of cashing it but to afford protection over its life, the pro rata amount of actual cost should appear among the assets and not the "short-rate" figure. Premiums for compensation insurance are ordinarily paid at first on the basis of the estimated payroll; they are later adjusted in accordance with the actual payroll.

Discount and expense connected with a bond issue are both regarded as prepaid interest for the use of the bond proceeds over the life of the bonds. If it is provided that the bonds are to be retired serially, more benefits will be received by the periods in which less of the bonds are retired and less benefits will be received

in periods when more of the bonds are retired. To prorate the bond interest and expense by the straight-line method over all the periods would, in the absence of other equalizing factors, not be satisfactory. Recourse in such a situation might perhaps better be had to the bonds-outstanding method, which may be illustrated as follows: If the auditor is dealing with $150,000 of bond discount and expense in connection with a $10,000,000 serial issue, half to be retired in 1 year and the other half to be extinguished in 2 years, the first year would receive the benefit of $10,000,000 of the bonds and the second only $5,000,000; the discount and expense of $150,000 would attach, therefore, to the equivalent of $15,000,000 of bonds for 1 year and would amount to 1 per cent; the first year, accordingly, should bear a charge of 1 per cent of $10,000,000 or $100,000, and the second year a charge of 1 per cent of $5,000,000, or $50,000; this method would absorb the whole charge of $150,000, but would do so more equitably than the straight-line method, which would allocate $75,000 to each year, regardless of benefits received.

The Committee on Accounting Procedure of the American Institute of Accountants concludes in *Research Bulletin* 2, entitled "Unamortized Discount and Redemption Premium on Bonds Refunded," that such discount and premium may be immediately written off against surplus or may be amortized over the term of the old issue.

In all these cases the auditor must ascertain the facts, make note of the manner in which they are treated, pass judgment upon the treatment, and make sufficient tests of mathematical accuracy to be satisfied. His work on the assets dealt with in this chapter will not differ markedly whether he is making a balance sheet or a detailed audit; in the latter type of audit he may make a more detailed examination of costs originally booked and of the amounts charged to the several operating periods.

Deferred Charges.—As examples of deferred charges, mention may be made of organization expense; developmental and experimental expense; promotional expense; alteration expense; leasehold improvements; and inventories of stamps, stationery, and office supplies. The asset has been acquired, the future is expected to benefit from its services; the question is how much remains as an asset and how much each period should be charged for benefits received. Here again the auditor customarily makes out a

schedule for each different asset, showing its movement from the beginning to the end of the period under audit.

The expenses involved in organizing a business are of benefit as long as it remains a going concern. For this reason they cannot be taken as a deduction under Federal tax laws. But custom decrees that they be charged off in a relatively short period (say, 3 to 5 years) for purposes of commercial accounting. To have operating figures comparable among the periods, it is necessary to show the write-off as extraordinary and nonoperating or to make it a direct charge to surplus. If it is small, the manner in which it is treated may be inconsequential. The auditor must study the figures composing the period's beginning balance, the changes, and the resulting ending balance, to determine whether the charge to the period and the amount remaining may be sanctioned.

Developmental and experimental expenses may result in no return; if they are for large amounts, to charge them to one year might distort the figures for purposes of comparison, unless they are put below the operating figures of the profit and loss statement; but if they are worthless, they cannot be shown as an asset. However, they may flower into patents with a legal life of 17 years plus the elapsed time between the filing of the application and the issue of the letters patent, and a useful life of perhaps something less. In this case effort should be made to allocate the costs equitably over the expected years of service.

Inventories of supplies not connected with manufacture are often valued at cost. Where they are important they may be handled as are other inventory items, but their relative unimportance in other businesses may lead to acceptance of estimates.

INTANGIBLES

Intangible assets may include goodwill, patents, copyrights, trade names, brands, trade-marks, secret formulas, franchises, and leaseholds. An analysis of each should be made upon a separate schedule by the auditor.

Practice as to the treatment of goodwill is not very satisfactory. Concerns with goodwill worth millions of dollars may not show it at all or at the nominal figure of $1; whereas others who actually have a small amount show it in large figures merely because they may have paid that much for it. The best indicator

of the continuing existence of goodwill is abnormally large profits year after year. The auditor should investigate the basis on which the goodwill appears in the accounts and decide whether he is satisfied with the company's policy, if any, as to amortization. Goodwill ordinarily should be shown only when bought and then at no more than cost. It is bad practice to conceal the purchase of goodwill costing millions of dollars; it would be better to show it first and then write it off or to attach an explanatory note to the reduced surplus on the balance sheet.

Although copyrights have a legal life of 28 years and may be renewed for another like period, their useful life is generally much less. It is sometimes wise to write their cost off against a first printing. The problem is analogous to that present in the motion-picture industry where the amortization of film costs has created a problem with which accountants have been struggling for 30 years with varying degrees of success. The early period is likely to receive the greatest benefit and should therefore bear the burden of most, if not all, of the costs. Good judgment, based on experience and a reasonable knowledge of facts, is the only guide as to whether a satisfactory showing of assets and expenses is being made.

Trade names, brands, and trade-marks may be registered for 20 years with the United States Patent Office. The registration is renewable for a like period. Their reasonable cost may well be capitalized and remain an asset as long as they are effectively used; this should be tested by the auditor through comparing the asset figures appearing upon the books with the sales of the related products. Not only should documents be studied by the auditor, but correspondence with the patent attorneys for the business should be perused. This procedure may throw light on the actual value of the asset and any obligations or liabilities connected therewith.

In spite of his best efforts, the auditor may not be able to do a very satisfactory piece of work in examining secret formulas. Sometimes they are bought in exchange for stock, and it is extremely difficult to determine what the dollar cost actually is. Acceptance of book figures with adequate mention of the facts may be the only reasonable thing to do. Naturally, since the formulas are secret, it is impossible to learn much about them. Something may be done, however, toward evaluating their use-

fulness in producing profits for the business. As long as they are sufficiently useful, the cost of acquiring them may be shown as an asset. The auditor should see whether they would be lost to the business upon the death of the only person who knows about them or whether their composition is recorded. A proper written assignment transferring title to the formulas to the business and adequate protection of the secret are also helpful to the auditor.

A franchise is a right granted usually for a definite period by a governmental body. Its cost, whether acquired directly or indirectly, is an asset which may reasonably be charged off over the period during which its benefits are realized. If it is the right to operate streetcars, the auditor must give attention to their possible supersession by private automobiles. Once again the legal life may not be the effective life. The possibility of the franchise's being lost should also be given attention by the public accountant. When possible, intangible assets should be shown in a separate section of the balance sheet.

CONTINGENT ASSETS

As the independent public accountant is doing his work upon the rest of the assets, he should be looking for clues suggesting the existence of contingent assets. In fact, contingent assets are frequently connected with contingent liabilities. If an endorser of a note happens to be called upon to meet his contingent liability, he should receive the note in return for his payment, and it, therefore, is a contingent asset, which becomes an actual asset upon receipt, although its value may be doubtful. Any business buying merchandise or raw materials may have awaiting settlement claims which are hard to evaluate. There may also be valid claims because of unfulfilled contracts or overpaid items. Sometimes possible financial calls upon stockholders and directors are contingent assets. Any of these may be important enough to affect the financial position of the business; if it is impossible to value them, they should receive mention in a footnote or in some other manner on the balance sheet.

QUESTIONS

1. What is the distinction between prepaid expenses and deferred charges?

2. What are the responsibilities of the auditor in connection with prepaid expenses and deferred charges?

3. What procedure should be followed in auditing prepaid expenses?

4. Where should prepaid expenses be shown on the balance sheet?

5. What are "short rates" used in connection with insurance policies?

6. What type of amortization is to be recommended for discount and expense on serial bonds?

7. What procedure should be followed in auditing deferred charges?

8. How should organization expense be accounted for?

9. How should the auditor verify developmental and experimental expense?

10. Discuss the accounting treatment of goodwill.

11. What are the auditor's responsibilities in connection with copyrights, trade names, brands, trade-marks, secret formulas, and franchises?

12. What procedure should the auditor follow in verifying contingent assets?

CHAPTER X

AUDIT OF LIABILITIES AND CAPITAL STOCK

In this chapter attention will be given to (1) current liabilities, (2) funded debt, (3) contingent liabilities, and (4) capital stock. When working with the assets, the independent accountant usually expects the client to prevent him from overlooking any of them; the principal balance sheet problem, then, relates to the valuation to be placed upon them. Human nature is such, however, that there is a temptation in many cases to allow liabilities to remain undisclosed; the auditor must, accordingly, be particularly vigilant to detect any signs of unrecorded liabilities. Once the liabilities are found, there is usually little real difficulty in evaluating them for statement purposes except in the case of some of the contingent liabilities, which may require the exercise of good judgment.

CURRENT LIABILITIES

Notes Payable.—The principal current liabilities of the ordinary business are notes payable, accounts payable, and accrued liabilities. Independent public accountants usually begin their work with the notes payable by obtaining or making a list of the notes with pertinent information, such as the payee, date of making and due date, interest rate, interest accrued to audit date, collateral, endorsers, and the purpose for which the note was made. This list must agree in detail with subsidiary records of notes payable and in total with the controlling account in the general ledger; any discrepancies should be investigated. The auditor must consider the control exercised over notes payable to determine the scope of the work to be done. He may be content to certify the notes payable as shown by the records if he finds, after suitable confirmation, (1) that a note register is kept in which all notes are recorded methodically, with each entry initialed or signed by the officers making the notes; (2) that control of notes rests with more than one person and that all of them must bear more than one signature of officials of independent authority; (3) that other

responsible officials must authorize the drawing of checks in payment of the notes; (4) that authorization for the issue of notes is clearly set forth in the minutes or otherwise; (5) that notes are taken from a consecutively numbered book so that all must be accounted for; and (6) that paid notes are systematically canceled and filed. This procedure is usual in a balance sheet audit.

In the event that the auditor believes that control is lax, detailed checking of the debits and credits made to the note accounts during the period under audit, scrutiny of cash records and interest accounts, and consideration of assets and the possibility of notes having been given in payment for some of them may take him into the realm of the detailed audit. At the time of seeking confirmations of cash, the banks should be asked for information concerning notes payable to them and about collateral being held as security. If they are asked to report endorsements, light may be thrown on the credit standing of clients unable to borrow merely on the strength of their own name. They should also be questioned regarding discounted notes not paid before the balance sheet date and thus carrying a contingent liability as of that time. Note brokers should be asked to confirm notes sold through them. All information received from these sources should be checked against the list of notes or working schedule prepared from this list. Any other notes payable large enough to be of importance should also be confirmed and checked. Notes paid should be examined; evidence of their cancellation should be particularly noted.

On the balance sheet, assets hypothecated as security for notes payable should bear appropriate mention of the fact. Chiefly on account of the fact that transactions giving rise to them are not at arm's length, the balance sheet should show separately notes payable to stockholders, directors, officers, and employees of the client or to an affiliated company.

Accounts Payable.—Accounts payable may be for trade or other purposes. Each type requires a separate showing on the balance sheet, as, for example, accounts payable to stockholders, directors, officers, and employees or an affiliate, if substantial. A schedule of accounts payable should be compared with the subsidiary records on the books and with the controlling account. The composition of items in the list should be investigated to see whether any important amounts represent old items which may be

in dispute or anything of a suspicious nature. Generally most accounting firms have not been in the habit of securing confirmations for accounts payable. They have believed that book records and statements from creditors provided all necessary information. One large firm, however, has for a number of years insisted upon confirming all accounts payable; it believes the practice to be thoroughly worth while. The trend will probably be to secure confirmations more generally. It must be borne in mind that suppression of liabilities on the books is comparatively easy and that confirmations will not reveal them. Any amounts appearing to be irregular should doubtless be confirmed; disputed amounts should be investigated.

If the internal check is thought to be satisfactory, little investigation is usually made of the bulk of the transactions of the period. Attention is directed primarily to the transactions of the last few days of the audit period and the first few days following. Unentered bills, vouchers entered after the close of the period, and cash paid then are reviewed to see whether or not they represent liabilities as of the balance sheet date. Receiving records for the close of the period are investigated to see that assets and liabilities have been properly recorded.

Liability should be shown for all goods received on consignment and sold. Review of receiving records and inquiry of responsible officials may reveal them.

When a detailed audit must be performed, the status of accounts payable may be checked by a detailed investigation of orders placed, goods received, and cash or other consideration paid on account. The amount of the payables as contrasted with sales and inventories may also be worth considering.

Accrued Liabilities.—The auditor should be careful to see that all accrued liabilities are shown on the balance sheet. Any types that have appeared in prior years should be on the balance sheet he certifies unless he can find a reason for their disappearance. He should consider each of the assets and liabilities and determine whether or not any accruals are to be expected in connection with them. Recorded expenses may throw light on those unrecorded and on accrued liabilities. The more he is satisfied with the internal check, the less intensive will be his investigation. Separate schedules may be prepared by the auditor for each type of accrual, or he may prefer to make his notations for accruals on the

schedules for the assets to which the accruals attach. He may have to make computations himself or merely check the accuracy of computations made by the client's staff. His work on a balance sheet or detailed audit will differ only in degree.

The auditor will naturally expect interest to be accruing on bonds and notes payable; on amounts due officers and directors for loans; on overdue accounts payable, taxes, or other liens; and on unsatisfied judgments rendered against the business. Taxes of various sorts will accrue to local, state, and Federal governments. If taxes have been withheld to be paid to the government, they must be shown as a liability. In some localities property taxes run from April to April and are payable in the fall; at June 30, therefore, 3 months' liability would have accrued. If the rate has not been published and the assessed value is not known, a satisfactory estimate can usually be made. Federal income taxes are based on the income for a period and are a liability at the end of that period, although they need not be paid until some months later. Income taxes for past periods may be in dispute and need to be reflected by a liability on the balance sheet or by an appropriate footnote. On account of the increasing significance of the liability for accrued taxes, much more attention must be given to them than has been the custom in the past. Amounts due lawyers, engineers, or other professional men should be ascertained from them in order that a complete showing of liabilities may be made. The lawyers should also be asked for information concerning damage suits or other liabilities which otherwise might not come to the auditor's attention. It seems reasonable that the auditor is entitled to rely on representations of this sort. Liabilities for such things as free repairs offered in connection with sales during a period should be considered.

FUNDED DEBT

A separate schedule should be prepared for each type of funded debt. Copies of bonds, indentures, resolutions, and contracts should be read carefully by the accountant. Pertinent notations concerning them should be made in his permanent file. The amount of bonds outstanding as shown by the books should be confirmed by the trustee. Amounts, interest rates, due dates, assets hypothecated, and payments made on mortgages should be confirmed by mortgagees. The accrued interest should be

checked, and the interest and discount charged to the period audited should receive attention; all items should be in harmony. Unless cremated, bonds redeemed should be inspected for cancellation. Any default in conditions of the issue, such as those relating to interest or principal payments, to the sinking fund, or to the maintenance of financial position during the life of the obligations, might make the amounts outstanding due and payable on demand, thus calling for mention in the statement of condition.

The balance sheet should show the various types of funded debt in detail. Indication should be made of interest rates and maturity dates. Any amounts due within a year should, if large, be shown as current liabilities unless sinking fund assets to retire them are shown as noncurrent or arrangements have been made to refund them without a drain on the current assets.

CONTINGENT LIABILITIES

Contingent liabilities may be noted while the auditor is doing other parts of his work. For example, he may ascertain facts concerning the liability for notes receivable discounted during his audit of the notes receivable. He should make a separate schedule for each sort of contingent liability. Sometimes contingent liabilities can be learned about only through inquiry of responsible officials. Connections of the client or its officers with other businesses should be ascertained, since endorsements or guarantees may have been extended by the company under audit as an accommodation to the other businesses. Security may have been given for the protection of the client; if so, it should be examined and valued. If mortgages have been assumed on bought property which was later sold, a contingent liability exists until the mortgage is discharged. Orders for purchases for future delivery should be investigated to ascertain whether commitments for large amounts have been made at prices substantially higher than market on the balance sheet date; unless they are protected by firm sales orders, it may be necessary to indicate the fact that the price is higher by a footnote to the balance sheet or by the creation of a reserve to absorb the loss. Likewise, if sales have been contracted for at relatively low prices and it is apparent that materials and labor to fill the contracts can be secured only at prices which will involve substantial losses, the facts must be revealed on the balance sheet. All large contingent liabilities must be adequately

disclosed if the statement of condition is to perform the service reasonably to be expected of it by the reader. In a detailed audit the auditor will have to make a more intensive search for these liabilities than would be necessary under conditions in which a balance sheet audit would be feasible.

When the auditor has done everything which he believes he reasonably should do as to the auditing of the liabilities, he should further protect himself by obtaining a certificate signed by responsible officials of the client. This should state that all liabilities for assets such as merchandise and for expenses have been shown in the accounts and should also contain a list showing any liabilities for damages, infringement, breach of contract, or anything else not recorded in the accounts. Some public accountants use forms for the clients to check, listing such contingent liabilities as the following:

Customers' or other notes discounted, sold, or otherwise transferred
Drafts negotiated
Federal and state income, profits, and other taxes
Accommodation endorsements
Guarantees
Leases (except as reflected on the books)
Bonds or other obligations of other companies
Contracts or purchase agreements above current market
Profit-sharing arrangements
Pending lawsuits
Repurchase agreements
Any other agreements
Fair-labor-standards act (Federal wage-and-hour law)
Accounts, notes, or other evidences of debt assigned to others with a guaranty of collection or under a repurchase agreement
Open balances on letters of credit
Additional taxes for prior years of which there is present knowledge based upon formal or informal advice
Any other pending or prospective claims, whether or not in litigation, such as claims for injuries, damages, defective goods, other than minor items arising in the ordinary course of business, for patent infringements, and deficiency judgments on real-estate bonds covering mortgaged property sold.[1]

CAPITAL STOCK

The situation concerning capital stock can be verified by the auditor only after he has made a study of the laws, charter,

[1] *The Journal of Accountancy*, March, 1941, p. 225.

bylaws, minutes, and specimen certificates. Much information of this sort should go into the permanent files at the time of the first audit, and additions should be made to it with the passage of time. The auditor should prepare a working schedule for each type of stock, showing the amount authorized, amount outstanding in the hands of the public, amount in the treasury, the dividend situation, and any other information which he believes to be useful. If the client's staff prepares the facts for the accountant, he should check them against the book records, certificate books, and documentary evidence. Attention should be given to whether or not the client is complying with tax laws relating to the issue and transfer of shares. Confirmation of amounts outstanding may in some cases be obtained from trust companies acting as transfer agents or registrars. Stock issued should be evidenced by cash or other consideration received. If issued for property or services, the authorization of the directors should be checked to see whether or not the consideration was properly booked. In the absence of fraud the directors' evaluation of composite consideration is usually acceptable to the courts.

By all possible means the auditor must try to learn about the existence of any options, warrants, rights, or conversion features connected with the stock. If they affect the financial condition of the company, the balance sheet must disclose the facts. The same would be true of stock sold under agreements to buy it back. It is well to note whether the directors appear to hold qualifying shares and whether share control may have an unwarranted bearing on salaries being paid. Dividends paid should be compared with outstanding stock. Liability should be shown for installment payments received for stock as yet unissued. Investigation should be made as to whether any such payments are in arrears or whether special favors are being afforded to any stockholders without express provision of the board of directors. The auditor should note whether enough stock has been authorized to meet commitments.

Presentation of the various types of stock on the balance sheet is governed to some extent by the laws of the state of incorporation, the charter and bylaws, and by the resolutions of the directors. The amount authorized, issued, outstanding, and in the treasury should be adequately indicated, together with the par or

stated value, if any. It is not customary to show stock of a going concern at redemption value, but the latter should be indicated. The Securities and Exchange Commission's Accounting Release No. 9 calls for exceedingly full disclosure in cases where the value in involuntary liquidation of preferred stock is substantially greater than its par or stated value. Of late years, showing of treasury stock as an asset is usually frowned upon to such an extent that if the practice is followed, it requires explanation on the statement of condition. Since most state laws provide specifically for the acquisition of treasury stock, the auditor must see that they are complied with. He must use this and other pertinent information to decide how treasury stock should best be shown on the liability side of the balance sheet. Sometimes treasury stock is deducted from capital stock to indicate the reduction of the amount outstanding; in other instances, it is deducted from surplus to indicate that it was acquired with earnings without impairing creditors' protection; and as a compromise it is frequently deducted from the total of capital stock and surplus. Earnings applied to the purchase of treasury stock are, of course, no longer available for dividends.

It is common practice to show par value stock at par and no par stock at stated value or at the amount received for it. Bases used should be clearly revealed. Any arrearage of dividends on cumulative preferred stock should be mentioned both per share and in the aggregate for each class, although they should not be shown as liabilities, since they have not been declared; otherwise the equity of common stockholders would not be adequately shown. As soon as dividends on stock are declared, they usually become an irrevocable liability; since they generally are to be paid within a year, they should be shown with the current liabilities until they are paid.

The above procedure concerning the audit of capital stock is what is normally called for in a balance sheet audit. In smaller companies involving inadequate control and check and the impossibility of receiving confirmation from reputable outsiders, such as trust companies acting as registrars and transfer agents, the auditor must do such additional work as seems reasonable to him under the particular circumstances. He may feel that it is necessary to receive permission to make inquiry of the client's attorneys. Then again it may seem desirable to have the stockholders confirm their holdings. Consideration for every share

issued may be checked minutely with the books and by any correspondence on file. Every certificate for stock retired may be inspected carefully for whatever clues it may afford, and the consideration given for it subjected to examination. It may appear helpful to the auditor to require responsible officials to sign a certificate dealing with all the important facts concerning each type of stock. On the other hand, if he is auditing a large company with an unusually good system of internal check, he should consider the possibility of omitting some of the work usually done in a typical case.

QUESTIONS

1. What is the auditor's chief responsibility in connection with liabilities?
2. What is the procedure to be followed in auditing notes payable?
3. What must the auditor do if he believes the internal control of notes payable is lax?
4. How should notes payable appear on the balance sheet?
5. Outline the procedure to be followed in auditing accounts payable.
6. Why should attention be devoted to transactions of the last few days of the audit period and the first few days following?
7. What is the procedure in a detailed audit of accounts payable?
8. How does the auditor determine what accruals need to be set up?
9. What types of accruals will the auditor find?
10. What schedules are indicated in an audit of funded debt, and how should funded debt be shown on the balance sheet?
11. What types of contingent liabilities arise in business and how may they be discovered by the auditor?
12. What should be done in connection with orders for purchases for future delivery and sales for future delivery?
13. What type of work is necessary in verifying capital stock?
14. Outline the audit procedure for capital stock.
15. How should treasury stock be shown on the balance sheet?
16. What are the customary bases of showing capital stock on the balance sheet?
17. How should the auditor's procedure in verifying capital stock vary in cases where internal control is inadequate?

CHAPTER XI

AUDIT OF SURPLUS AND RESERVES

In this chapter the procedure used in auditing the various types of surplus, including the profit and loss items giving rise to earned surplus, will be discussed, and reserves will be covered to the extent that they have not already received consideration. Unfortunately some disagreement exists among accountants as to both surplus and reserves. Further study and discussion will doubtless iron out the difficulties with the passage of time; in the meantime the auditor must rely upon adequate disclosure of the facts for his protection.

SURPLUS

In general, surplus is of three sorts: (1) paid-in or capital, (2) revaluation, and (3) earned. However, for the sake of simplicity, it is quite general today to classify surplus as either (1) capital or (2) earned, in which case revaluation surplus is included with capital surplus. The public accountant's job is to analyze the changes in the surplus accounts for the period under audit. In a first engagement he should make a satisfactory review of the surplus accounts from the inception of the business. Important points noted in this study may be incorporated in the permanent file for general guidance on later investigations. A schedule should be prepared for each type of surplus showing the beginning balance, the additions and deductions during the period, and the ending balance to be shown upon the balance sheet. The auditor should examine one type of surplus at a time. Since the examination cannot be of a routine, mechanical nature, the most experienced personnel participating in the engagement should undertake this work.

Paid-in or Capital Surplus.—In examining the paid-in or capital surplus, the auditor should seek to uncover its origin. The surplus may have arisen through sale of capital stock at a

premium, in which case it should be checked against the appropriate resolution of the directors and against votes of stockholders. The proceeds of the sales should ordinarily, because of their importance, be checked against the records of cash receipts. Then again this surplus may have arisen through a write-down of the capital stock account. In that event the stockholders' votes, resolutions of directors, correspondence with attorneys, and appropriate state laws should all be studied by the accountant in order that he may have a clear picture of the situation. In a study of this sort there will be little difference in procedure, whether the public accountant is performing a balance sheet audit or one supposed to be more detailed. His study of the origin of the various amounts in the account may serve to familiarize him with the meaning and significance of the individual credits and it may serve the more important purpose of instructing him concerning managerial policies and procedures of the business being audited. If he finds this account credited because of a donation of the company's stock to the company, he should ask the reason for the donation. Perhaps originally an excessive amount of stock was issued for overvalued property in order that it might be considered fully paid. If the stockholders then donated it back to the company to be sold for whatever cash it would bring, the accountant is on notice that the overvalued property cannot be said to be shown at cost. He is also made aware that the men with whom he is dealing may have resorted to legal technicalities in order to achieve their purpose.

The charges to the capital surplus account should likewise have a thorough investigation. The auditor should be especially on his guard to see that by debiting capital surplus, past, current, and future earnings are not relieved of charges which they should reasonably bear. For instance, a reorganized company may give effect to changed conditions by writing down its assets. The result may be that the future will have less charges to bear, for example, for depreciation. The Securities and Exchange Commission's Accounting Release No. 1 gives the opinion of the Chief Accountant that "capital surplus should under no circumstances be used to write off losses which, if currently recognized, would have been chargeable against income." If assets have been written down without the formalities of reorganization—a situation that is known as a quasi-reorganization—it may be

satisfactory to charge capital surplus, but only if earned surplus has been exhausted, the transaction has been clearly described to the stockholders, and they have given their approval. This is discussed in *Research Bulletin* 3 of the American Institute of Accountants. Any new earned surplus should, according to Accounting Release No. 15 of the S.E.C., be dated so as to reveal the period during which it was acquired. Release No. 16 requires exceptionally full disclosure to stockholders in cases where their approval was not required by law.

Losses and gains on dealings in treasury securities may give rise to changes in the account during the period. In fact, S.E.C. Accounting Release No. 6 states emphatically that they shall be charged or credited to capital surplus and not to earned surplus. Although accountants generally frown upon dividends which are charged against capital surplus, these are lawful in some jurisdictions. The auditor must study all the facts and then seek a means of sufficiently revealing them. Stockholders who are receiving back part of their investment as a so-called "dividend" should be told what the situation is; otherwise they will doubtless believe that they are getting earnings on their investment.

Revaluation Surplus.—Although it is considered good practice to book fixed assets at cost and depreciate them over their useful life, there is a temptation to write them up to what is believed to be their market value in times when there is a drastic rise in the price level. This procedure violates conservative practice, but it is argued that it leads to a more informative treatment of these assets on the balance sheet. The auditor should see that surplus arising through a write-up of this sort is clearly labeled, in order that the balance sheet reader may have no doubt as to its origin. "Surplus Arising through Revaluation of Fixed Assets" would appear to be a clear statement of the facts. Fifteen years ago, when writing up assets was a relatively common occurrence, accountants recommended charging depreciation based on cost to operations and charging the depreciation of the appreciation to the surplus arising through the revaluation. In this manner the latter would presumably be extinguished by the end of the useful life of the related assets. A company using these supposedly valuable fixed assets and charging operations with depreciation based on a low cost would be expected to show unusually large profits, which would come to rest, at least temporarily, in earned

surplus. Thus it was thought that the appreciation was realized in the excessive earnings.

Now, however, accountants believe that proceeding in this manner does not charge operations enough for the use of the assets whose larger value has been publicly paraded as an inducement for the offering of funds to the business. They advocate that depreciation charges to operations be based upon the appreciated value of the assets and that the corresponding credit be made to the regular Reserve or Allowance for Depreciation. The surplus arising through the revaluation procedure is transferred piecemeal to earned surplus as it is realized through operations. Of course, the final results are the same in the balance sheet, but operations show smaller profits during the period when the assets are in use. These matters are discussed in *Research Bulletin* 5 of the American Institute of Accountants. The public accountant must see to it that statement readers are adequately informed as to changes in accounting methods employed and as to their significance. The procedure when the independent public accountant is dealing with this type of surplus will probably not differ, whether he is undertaking a balance sheet or detailed audit.

Earned Surplus.—Earned surplus should be the most important type of surplus, since business lives to earn. It should show all net earnings which have not been made the basis for dividends, whether arising from ordinary operations or from extraneous sources. If the assets and liabilities (including capital stock and capital surplus) have been carefully verified, the auditor will know that the balancing item is earned surplus but he should test this figure independently, especially as a basis for his certification of the statement of profit and loss for the period. In a first audit the public accountant must make such investigation of the history of earned surplus since the beginning of the business as he believes to be necessary; afterward he may begin with the balance as of the beginning of the period under audit, study the changes, and thus arrive at the final figure which he believes he can safely certify.

In some cases dividends have been paid in part out of earned surplus and in part out of capital or some other kind of surplus, and the balance may be hopelessly confused. In such case separation can be made only for such period as the records permit. Some accountants believe that it is more important to show surplus

available for dividends than to make a distinction between earned and capital surplus. Memoranda, authorizations, and discussion will help the auditor form conclusions. Charges for dividends should be checked against the directors' votes. If they represent stock dividends, it should be especially noted whether or not the charges are in harmony with what the directors voted, particularly in connection with no par stock. Otherwise, the charge to surplus and the credit to the stock account may be unduly small, with the result that a small surplus could be made the basis for the distribution of an unwarrantably large number of shares. The facts should be clearly revealed.

In connection with the above it should be noted that no unrealized profits are taken into earned surplus. Accountants are reasonably fair today as to what profits they are willing to consider earned. In the latter part of the nineteenth century it was common practice not to consider them earned unless the cash was received. Now they are taken into income as soon as sales (with shipment) give rise to valid claims, unless under the particular circumstances collection of the proceeds is in unusual doubt. Some persons who would not do so directly attempt to obtain comparable results by making charges against unrealized profits which should normally be made against operations, with the result that operating profits appear more favorable than they should. Profits from installment sales are fairly commonly deferred over the period of collection; the auditor's task is to examine the profit situation with a view to ascertaining whether reasonable allocation of profits is being made over the various periods. Intercompany profits should not affect the consolidated surplus figures until they have been realized by sales to parties outside the affiliated group. Interdepartment profits likewise must be realized through sales to outsiders before they may properly affect the company's surplus.

In preparing consolidated balance sheets, the auditor should remember that the surplus of a subsidiary company earned prior to its acquisition by the parent and represented by its assets is bought and paid for when its stock is bought. Except in unusual circumstances, it forms no part of consolidated earned surplus; any dividend out of it is a return of investment and not income to the parent company.

Before consideration is given to the examination of the profit and loss accounts, whose results ordinarily have a most important

effect on earned surplus, some attention must be given to the earned surplus as it is to appear upon the balance sheet. Frequently restrictions are imposed upon its use. In some of the states treasury stock can be bought only with earnings; once having been used in this manner, the surplus is no longer available for other purposes, even though the entry for the acquisition of the stock was a debit to Treasury Stock and a credit to Cash. Sometimes charter restrictions are present. Then, again, the provisions of a bond issue may contemplate the retention of earnings to strengthen the position of the buyers of the bonds. In all cases of this sort the public accountant must not give his unqualified approval to the balance sheet unless the restrictions are clearly set forth.

Profit and Loss Items.—In a detailed audit the public accountant would subject sales and deductions, purchases and deductions, operating expenses, other income, and other expenses to a meticulous examination. Sales would be compared individually with orders, shipping records, receivables, and cash receipts. Discounts would be checked against the terms of all sales. Credit memos and authorizations would be inspected in every case. Requisitions, purchase orders, receiving records, payables, cash payments, goods sold and on hand would receive individual attention and be weighed thoroughly against one another. Operating expense accounts would be investigated minutely, compared with the budget, and considered in the light of prevailing operations. Other income would be checked back painstakingly to its sources. Other expenses would receive like consideration.

In a balance sheet audit, however, reliance upon the accounting system and its operation and upon the internal check allow the accountant to dispense with a large part of this routine work. As a precaution, the auditor may give an intensive study to a short period, say, a month, and quite commonly he gives close attention to year-end conditions to ascertain whether cut-offs between periods are being fairly made. Beyond these checks the auditor usually depends upon over-all tests to see whether figures are equitable in the light of each other. His examination of the system should enable him to determine whether items are properly classified. Comparison of figures for the current period with those of the preceding should lead to conclusions as to the reasonableness of current figures, items subject to inquiry, and, perhaps,

significant facts as to the operations of the business under audit. Budget figures and monthly statements should be studied for the same purposes. Just what over-all checks an auditor will use in a given case must depend upon his judgment as to the conditions he finds.

Usually it is good practice to show sales figures on profit and loss statements, since they may be of vital interest to readers, but trade conditions sometimes make their revelation inadvisable. The cost of sales figure should be looked into enough to see that it includes all costs of buying and producing goods and no others. Large extraordinary expense items should be watched closely. The percentage of net profit to sales should be figured and questioned as to its reasonableness in comparison with the results for former periods. Adequate disclosure should be accorded substantial or unusual items of other income. Dividends on treasury stock should not be used to inflate income. Other expenses must not be used as a device to relieve operations of charges they should bear. Adequate provision for taxes upon income or for the privilege of doing business could be made under this heading or in a separate section of the statement. To prevent their being overlooked, it is advisable to include surplus adjustments of a minor nature having reference to prior periods in the lower part of the profit and loss statement, rather than to carry them directly to surplus. As *Research Bulletin* 8 of the American Institute of Accountants points out, it is sometimes desirable to combine the profit and loss statement for a period with a statement of surplus changes. An adequate ratio study of the profit and loss statement may serve to enlighten the auditor and may also serve to produce useful information to be incorporated in the report to the client. The gross profit test may be helpful in this respect and may be a check upon the accuracy of the inventory.

RESERVES

Reserves are confusing because of lack of standardization in the use of the term. It is used to represent the following: current liabilities, such as those for accrued taxes; valuation allowances, such as the Reserve for Bad Debts or for Depreciation; and true reserves, that is, appropriations of surplus, or contingency reserves arising from charges to operating expense. The auditor should consider the composition of beginning balances, period changes,

and resulting ending balances to be certified. In a balance sheet audit general policies adopted may be all that require investigation; in a detailed audit perhaps it will be necessary to make a thorough study of every debit and credit. Valuation reserves are best deducted from their respective assets and liabilities on the final certified statements. True reserves, being segregated surplus, should be shown in the surplus section of the balance sheet. Investigation of the reasons for setting up such reserves and of the type of charges to them may give the public accountant a useful insight into managerial policies and procedure. It is sometimes helpful to furnish readers a statement concerning reserves and their changes in addition to the ordinary balance sheet, profit and loss statement, and statement of surplus changes, since occasionally reserves are debited for charges which would otherwise have to be borne by operations or surplus.

GENERAL CONCLUSIONS ON AUDIT PROCEDURE

The work of the auditor with the client's books and records, usually on the client's premises, has now been surveyed. His usual duties in the conduct of a balance sheet audit in a medium-sized business have received chief consideration; an attempt has been made, however, to indicate the sort of things which he must do where a more detailed job is necessary before his approval of the statements is warranted. When conditions are unusually satisfactory, as might be the case in some of the country's largest businesses, the auditor may consider whether to dispense with some of the more or less detailed work commonly done on a balance sheet audit. For example, where notes and accounts receivable are handled by a first-rate system, a study of the system may be more satisfying than a thoroughly detailed audit of the notes and accounts. No matter how good the inventory and stock control is, accountants now believe that the auditor should make some physical inspection of inventory, but what he does in this respect is a matter of judgment. If he is satisfied that the manner of controlling fixed assets and the related depreciation is unusually efficient, limited tests of a few of the larger items may be all that are necessary. If the public accountant does what is reasonably called for by the conditions with which he is confronted, that is all that should be expected of him. To do this is no easy task, however, and opinions vary, so that it is no wonder that the

conclusions of some of the best accounting firms are at times questioned. They should not be blamed, nevertheless, for honest mistakes; hindsight is invariably better than foresight.

The Journal of Accountancy for March, 1941, contains a statement by a committee of the American Institute of Accountants which may suggest the possibility of further protection for the public accountant:

COMPREHENSIVE WRITTEN REPRESENTATIONS COVERING THE BALANCE-SHEET IN GENERAL

A comparatively small number of firms, which handle a substantial proportion of audit work done by the profession, require comprehensive written representations signed by the treasurer, comptroller or other executives.

The subcommittee sees no objection to this practice, but the evidence available indicates that it is in use only to a comparatively limited extent. However, the following summary is considered to be of sufficient interest to be presented for the information of members. In each case, representations concerning inventories and liabilities are included in these comprehensive representations, but as these matters have already been dealt with separately, nothing will be repeated under these headings. The following items are covered in the practice of one or more of the firms referred to:

Property, Plant and Equipment

1. All charges to fixed asset accounts represent actual additions.
2. Sales, dismantlements and abandonments have been properly accounted for.
3. The company has title to property included in plant, machinery and equipment accounts.
4. The basis on which the property has been carried is properly described in the statements.
5. All property, plant and equipment is being utilized in current operations or exceptions are noted.
6. The property is maintained in an efficient working condition.
7. No obsolete machinery or equipment is included in the asset accounts.
8. All property, plant and equipment has been paid for or liability therefor taken upon the books.
9. There are no liens or encumbrances on properties except as recorded on the books.
10. If properties are appraised the results of the appraisal as compared to the book value are fully and fairly set forth.

Reserve for Depreciation

1. In the opinion of the signer of the representation the annual provision for depreciation and depletion is adequate except as noted.

2. The total reserve for depreciation as compared with the asset is adequate at the date of the balance-sheet.

3. The basis for providing depreciation is consistent with the previous year or exceptions are noted.

Accounts Receivable

1. The notes and accounts receivable of the corporation represent valid claims against customers and other debtors.

2. Indebtedness of officers, stockholders and persons directly or indirectly controlling or controlled by the corporation and persons under direct or common control with the corporation is correctly stated in the statements.

3. Accounts receivable in respect of material or merchandise shipped on approval or on consignment are so described in the accounts-receivable records of the corporation.

4. Accounts receivable hypothecated or assigned are so described in the records of the corporation.

5. The accounts receivable as summarized do not include any charges in respect of material or merchandise shipped subsequently to closing date.

6. The accounts receivable as summarized above are not subject to deductions for discounts other than cash discounts not in excess of 2 per cent, for allowances in respect of defective material or merchandise, transportation charges, price adjustments, or for any other deductions of similar nature except as provided for by the corporation in its reserve accounts.

7. All notes and accounts receivable as at the closing date that are known to be uncollectible have been charged off as at that date.

8. In the judgment of the signer of the representation, the amount of $........ provided as a reserve for doubtful notes and accounts is adequate to provide for any losses that may be sustained in collecting the notes and accounts due from customers and other debtors as at the closing date.

Minute Books.—A letter from the secretary of the company stating that the minutes furnished to the auditors are true, full and correct.

Special Provisions in Representations.—One firm requires a statement that reserves are adequate for the purposes for which they are set up; that no extraordinary or nonrecurring items of income or expense are included in the profit-and-loss account except as noted; that the accounting principles and policies followed during the period are consistent with those followed during the previous period except as noted; and that officials of the company know of no additional material facts not shown on the books of account or made known to the auditors in writing.

Another firm requires a statement in regard to income taxes; a statement that there are no matters of strictly personal or private nature adversely affecting the successful continuation of the operations of the company known to exist at the balance-sheet date or which

have arisen since; and a statement that, to the best of the knowledge and belief of the company officers, no shortages or defalcations have occurred which would affect the audit.

A third firm requires a statement that no events have occurred or matters been discovered since the balance-sheet date which might render the balance-sheet as of that date, or the profit-and-loss or expense statements, untrue or misleading; that no special matters have occurred during the period covered by the financial statements except as noted; and that there have been no shortages or irregularities not disclosed to the auditors which would have a bearing on the statements. In addition there is a statement of the understanding of the company officers of the scope of the audit and a statement that there have been no intentional omissions by the company officers to state material facts to the auditors.

QUESTIONS

1. What types of surplus are there?
2. What is the public accountant's job in auditing surplus?
3. Of what importance in an audit is the origin of capital surplus?
4. What particular danger should the auditor watch for in verifying the charges to capital surplus?
5. Discuss the practice of writing up fixed assets in accordance with rises in the price level.
6. What are the two methods of eliminating revaluation surplus and which do you think gives a better portrayal of the facts?
7. What should earned surplus show?
8. How should dividend payments be verified?
9. What principles underlie profit realization?
10. How are profits from installment sales generally handled?
11. What attention needs to be paid earned surplus in preparing consolidated balance sheets?
12. Discuss the balance sheet presentation of earned surplus.
13. What procedure would be followed in a detailed audit of profit and loss items?
14. How does the procedure for a balance sheet audit differ in this same connection?
15. Should sales figures be shown on profit and loss statements?
16. Where should minor surplus adjustments be shown?
17. Of what value is a ratio study of the profit and loss statement?

18. What dissimilar accounts are covered by the term "reserves"?

19. What procedure should the auditor follow in verifying reserves?

20. How should the various reserves be shown on the balance sheet?

21. What type of conditions must be present before an auditor may dispense with some of the more or less detailed work commonly done on a balance sheet audit?

22. Is some physical inspection of inventory now considered necessary?

23. What type of written representations could an auditor secure?

24. What general conclusions do you draw from the foregoing consideration of audit procedure?

CHAPTER XII

PRESENTATION OF FINDINGS

Every audit is made for a purpose, and therefore the persons for whom the work was done expect a report of some sort as to the conclusions reached by the auditor. Although the record of the work is first incorporated by the public accountant in the working papers, which are prepared for his own convenience and assistance, those papers will not be discussed here, since pedagogically it was thought best to consider them in an early chapter. We are concerned then with reports made by independent public accountants to the persons in whose behalf they were employed to perform the audits.

PREPARATION OF THE REPORT

All through the course of the audit those in charge should have in mind the fact that the fruit of their labors is to be a report adequately disclosing reasoned conclusions to a more or less definite person or group of persons. The auditors should try to make their working papers render the greatest possible aid in the preparation of a satisfactory report. It is sometimes considered good practice to start a few schedules during the audit, so headed as to contain conveniently pertinent comments and remarks to be included in the report. Any device of this or any other sort which the particular auditor believes will be worth the time and effort involved should doubtless be employed. As far as possible everything should be ready for the preparation of the report when the auditing work is completed.

The auditor should not delay preparation of the report unduly. It has been all too customary to accuse him of being a historian specializing in events of the past. He is expected to be the acme of accuracy and precision; it ill becomes him to be dilatory. What he has to say may well be of more interest and help if said soon. It may also be of interest to suggest that probably he cannot collect before the job is finished. If he wishes to be

known as a constructive business consultant and not merely as a recorder of what has already happened, and if he wishes to be regarded as an effective force in modern business, he must complete his work with dispatch, in spite of the presence of busy seasons. If the report is tardily prepared, it may be necessary to make an examination of the period between the balance sheet date and the date of the report.

Although it has been assumed up to this point that the report should be prepared in the auditor's own office rather than in that of the client, it is by no means certain that this practice should always be the rule. Every public accountant should prepare reports where he can do them best. If he finds that in the course of report writing he must continuously telephone, write, or see the client's personnel for more information, or if he finds it necessary to inspect the books and records or anything else of a pertinent nature, it may be more satisfactory to try to find a suitable place to work on the client's premises. By so doing the client may become aware of the fact that time-consuming effort is being exerted in his behalf; the bill may, perhaps, be more cheerfully paid for this reason. However, conveniences may not be so available in the client's office as in that of the public accountant.

The report should be written, if possible, by the person who knows most about the situation, the senior in charge of the engagement, but many seniors who can carry on the audit procedure itself satisfactorily seem unable to prepare effective reports. Since such employees correspond to salesmen who can do everything but clinch sales, there is a definite limitation on their usefulness to their employers and their progress is surely impeded. If the senior cannot write the report, the manager or supervisor or a partner or principal must; this task will take his time and attention from other work of perhaps an even more important nature in a thriving organization.

In a large organization when a rough draft is completed, it is ready to be handed over to the report department. In this department the finished product of the original compiler should be checked against the working papers, itself, and computations made in the writing of the report, to eliminate mistakes and inaccuracies of every description. It is foolish to claim that accountants do not make arithmetical mistakes; they are only human. The notion that they must never make errors puts an

unwarranted burden upon them. However, care should be taken to see that mistakes are kept to a minimum and that those which slip by are of relative unimportance. After it has been checked, the report may be reviewed by a manager or principal, unless it seems better to have it typed first for his convenience. When it finally contains what the firm wants the client to be told, it is ready to be typed neatly and attractively, bound, finally reviewed, and signed with the firm name. It is sometimes advisable or required for a partner affixing the firm name to add his own also. At least one copy should be retained for the files of the firm. It may be necessary to have it in order to prove that issued copies were altered. Before release of the report, the auditor must think of all sorts of responsibilities which it may cast upon him. He may well consider whether watermarked paper should be used for his protection, whether one part of the report might be used wrongly without another, and whether everything which ought to have been done has been done to justify its issuance.

Usually reports are sent to clients by registered mail or messenger. If delivered by a principal who has an appointment with a responsible official of the audited business, occasion might be found sometimes for valuable discussion of its content. Of course it may be that the report in tentative form has already been considered with the client; in that case, delivery of the finished product might adequately take place through a messenger.

Although the public accountant must be independent and must not be swayed unduly by the client's wishes, he should learn all that he can concerning what he is attempting to do, not only from his contact with tangible things but also from his inquiries and discussions with the client. If he finds that it is possible to be cooperative and still maintain his independence, it will be helpful for him to accede to reasonable requests. It is easy to be stilted, offish, and dogmatic; it is better to understand sympathetically the reasoning, conclusions, and feelings of others, but nevertheless to remain an apostle of the truth.

CONTENTS OF REPORTS

Most people who read business reports are busy. They want useful facts and opinions and they want them quickly. This last requisite implies that they want them expressed so simply and clearly that they can be understood without difficulty. Of

course their interest must be maintained or the report is worthless. If the report begins by conveying such interesting and important information that it is thoroughly enlightening and opens up new channels of thought and points of view to the reader, he may be tempted to read supporting detail in later parts of it.

If the report is long, it should have a table of contents or an index. The reader who wishes to find information on a given point will, then, not have to waste time looking through various pages before he comes upon what he is seeking. A table of contents that is nothing but padding for a short report should be omitted.

The introductory portion of a report frequently serves as a letter of transmittal. It can tell what was done, for whom, and what the results were. In some cases it may give a short résumé of the history of the business, if, for example, this would be useful and interesting to a prospective purchaser. Its chief purpose may in many cases be to secure the interested attention of the reader. Knowledge of him may, therefore, be the writer's best guide as to what should be included and the manner of its inclusion.

The introduction may be followed by a section of comments or discussion. The typical efficient businessman usually wants something more than mere compilations of figures; it takes time to understand their significance. It is better to state the facts clearly and briefly, depending upon schedules and tables to amplify them if necessary. The auditor must use good judgment in choosing things worthy of mention; after all the client does not expect to pay by the pound for what is reported. Too many reports comment on each asset, liability, expense, and income item in a boring, uninteresting manner, whether or not there is anything worth saying. Businessmen have neither time for nor interest in reading such reports. Useful information may include significant facts as to the financial position of the business and its trends. If comparative statements or a statement of source and disposition of funds will portray the facts more clearly, recourse should be had to them.

If operations rather than financial position are of outstanding importance, they should be the first to receive consideration. Comparative statements and ratios derived from them may be the means of driving home the lessons to be taught. If there

has been a significant change in an important operating item, the auditor should if possible ferret out the reasons and report them, unless he believes that the reader already is aware of them. For example, suppose that gross profit has been diminishing steadily for a few years. Would it not be instructive to the reader to know whether failure to obtain ordinary sales at attractive prices, or poor purchasing policies, or inefficiency in the factory, or approaching managerial dotage, or governmental interference, or some other possible cause capable of some measure of correction was the source of the difficulty? The section of comments is ordinarily the part of the report in which to teach and instruct. If the lessons can be more effectively taught by charts or graphs and the auditor has facilities for preparing them efficiently, he may justifiably make use of them. Probably this section of the report should in many cases be limited to discussion of operating conditions and financial position. It may be more effective to treat in a separate or supplementary report other matters, such as the advisability of installing a budgetary system. suggested changes in the general accounting or cost accounting system, or the advantages to be gained by the introduction of machine accounting. It is generally advisable not to try to cover too many different types of things in one lesson.

Although the auditor must not appear to be a prophet and soothsayer, he should attempt to be more than a business historian. The figures in the books are worthless save for the use that may be made of them. There is no reason why the auditor, expert in accounting figures as he is supposed to be, should not bend every effort in an attempt to reveal their significance not only as pertains to the present but also to the future. Can there be anything but benefit in showing a client that if he continues to allow expenses to grow, he must inevitably meet disaster? Naturally the more help the client believes he gets from the auditor's report, the more he will value the work done.

It is both appropriate and common practice to put the balance sheet, operating, and surplus statements at the end of the report. All too frequently they are accompanied by schedules and tables of questionable merit. Whatever statements are presented should be prepared with the greatest of care. The arrangement, the captions, the footnotes, and any comments should have continuous close study and review before they are approved.

Loopholes, ambiguity, double meaning, and the like should be sought out and eliminated.

Reports to prospective buyers or sellers of a business, to management for its guidance in making business plans and carrying them out, to management in cases such as those of defalcation, to investment bankers and the public in connection with security issues, and reports on special problems allow the auditor more scope than the ordinary report to show his ability as a writer. In several of these cases his audience is fairly definite; he should ask himself what they need to know and how it may best be conveyed to them. Often he will do well to try to put himself in their place.

CERTIFICATES

It has been customary to include in reports to stockholders and with statements issued for purposes of securing credit a fairly short report, which has generally been known as a certificate. The term "certificate" is coming into disrepute in certain quarters and probably for good reason, but it has been retained in these chapters as a matter of practical convenience and because most businessmen think they know what is meant by an accountant's certificate.

As a matter of fact, the profession was unwise ever to adopt the word "certified" in connection with the certified public accountant or "certificate" in relation to reports. The corresponding English term to denote a public accountant who has passed certain examinations to test his qualifications, "chartered accountant," seems distinctly better, although it clearly lacks perfection. In England the tests are given by professional societies which are not qualified to grant charters, licenses, or other permission to engage in a given pursuit, as can a governmental division. It has not been customary to speak of other professional men in this country who have passed qualifying tests as certified physicians, certified dentists, or certified lawyers. Even if it were, intelligent persons would still wish to discriminate among those who had succeeded in passing the requirements. The preference above expressed for "chartered" rather than "certified" comes from the fact that the former seems to imply a license rather than the guarantee which seems involved in "certified."

The word "certificate" also connotes a guarantee, and its use is probably unwise. A public accountant has repeatedly been

held by the courts not to be a guarantor. Why should he wish to shoulder this unnecessary burden at a time when his load is becoming onerous to the point where he may well cringe before his responsibilities? The honest opinions of qualified men are what is wanted in a report; nothing more can reasonably be asked. If the state can help in the selection of qualified men, it is rendering a service to the common good, since business affects us all. The state guarantees the qualifications of no man; it merely tolerates his pursuit of the vocation for which he is licensed. Happily, terminology is receiving much attention, and improvement will doubtless come soon. Meanwhile "certificate" means a relatively short report with a special connection to one or more statements on which opinions are expressed.

Certificates may be very brief, brief, or not so brief. The very brief variety is more or less a relic of the past. For most purposes, it smacks too much of an unqualified guarantee.

Those consisting of three or four relatively short paragraphs are more usual today and a standardized form, recently revised, with modifications to suit particular situations, seems to be reasonably satisfactory. Concerning this form, the pamphlet entitled "Extensions of Auditing Procedure," October, 1939, says:

FORM OF INDEPENDENT CERTIFIED PUBLIC ACCOUNTANT'S REPORT OR OPINION

The services which independent auditors render usually culminate in a report, which may take varying forms. In some cases a detailed report is rendered, accompanied by statements and supporting schedules; in other cases the report is limited to a concise statement of the scope of the examination and the related opinion of the independent auditor concerning the accompanying financial statements of the client. For present purposes the discussion is confined to the short form of auditor's report, which is sometimes described as a certificate. The terms "report," "opinion," "report and opinion," and "certificate" have been used interchangeably. As uniformity is desirable, either of the words "report" or "opinion" is recommended for general use. The word "report" has been adopted in the following comments.

In January, 1934, the Institute issued a pamphlet entitled *Audits of Corporate Accounts*, dealing with a standard form of auditor's report. The short form of report then recommended, and since widely adopted by the profession, met a long-felt need.

Developments during the five years in which the standard form of report has been used indicate the need of revision in the interest of clarity. The revised short form of report consists of two paragraphs.

The first contains a brief statement of the scope of the examination, and the second deals with the auditor's opinion on the financial statements of the client as a result of his examination.

The major changes recommended pertain to the description of the scope of the examination, specifically to include reference to the system of internal control. The phrase "obtained information and explanations from officers and employees of the company" has been omitted because it is inherent in all auditing procedure to obtain information and explanations from officers and employees concerning the accounts, either as supplementing information obtained from other sources or as constituting the only available information on the subject. In the latter case, the auditor must decide, in view of all the circumstances, whether he should rely upon such information without disclosure of the source. The phrase in question has led to serious misconception as to the degree of reliance on such information and explanations. The sense of the statement "but we did not make a detailed audit of the transactions" has been retained in a revised form. It will be recalled that this clause was included in the standard form of 1934 in order to make clear that the auditor's usual procedure consisted of testing and sampling rather than a detailed audit. It is believed that the business and financial public now fully understand that, in a well organized concern, the detection of irregularities is primarily a matter of internal procedure, and that testing and sampling to determine whether such procedure is adequate in scope and effective in operation is the usual practice of the independent auditor. Nevertheless, it is considered advisable for the purpose of emphasis to include the phrase, "without making a detailed audit of the transactions." There has been excluded the phrase "based upon such examination," as it is obvious that the independent certified public accountant can express an opinion only after he has completed the work set forth in the first paragraph of the report.

The independent certified public accountant should recognize that in some cases the revised short form recommended may not be altogether appropriate. For instance, there may be cases where the auditor may prefer to alter the first sentence of the standard short form, substituting some words to the effect that the accounting records (instead of the financial statements) have been examined. Obviously, also, it would be erroneous to mention internal control if none existed. Accordingly, while the proposed form is submitted as a standard, it is not prescribed or recommended for invariable use, but should be adapted to the needs of the particular case. For example, the report may be used in connection with an examination covering a period of years, in which case a modification of language would be necessary. Also, in new engagements appropriate investigations relating to prior years will have to be made to justify the use of the short-form report. However, in the interest of reasonable uniformity it is recommended that the substance of phrases in the standard form be used unless inappropriate.

In considering the independent certified public accountant's opinion, the reader should bear in mind one of the most important underlying concepts of financial statements, viz., that normally many of the assets of a concern are not realizable in cash, but are commonly stated at their historical cost or going-concern basis at amounts which are usually greater than the realizable value in forced liquidation. Again, the true profit or loss of a concern can be determined with accuracy only over its entire existence. Therefore, in any attempt to allocate to specific periods profit or loss applicable thereto, it must be recognized among other considerations that, as many transactions are not fully completed within such periods, the result as shown must contain many estimates and approximations in the endeavor to present fairly the operating results of a period in conformity with generally accepted accounting principles.

Assuming that normal procedures have been carried out, it is not considered necessary to describe the details of the examination in this form of report. Any such details as are given should be included in separate paragraphs of the report. For example, reference may be made to procedures which the accountant has adopted regarding the examination of inventories and receivables; also, it may be pertinent to mention the fact that certain portions of the auditor's work have been carried out at different times during the course of the year. This may be indicated by inserting the words "at times" in the first paragraph of the short form of report immediately after the words "by methods."

It should be borne in mind that the financial statements, with all supplemental descriptive and explanatory data, including footnotes, are regarded as representations of the client. It is upon all these representations that the independent certified public accountant renders his opinion. If he considers explanations essential or desirable, and they have not been made in the financial statements, it will be necessary for him to make such explanations in a separate paragraph of his report.

In explanation of the general principles governing the auditor's opinion, with particular regard to explanations and exceptions, it is pertinent to state that the auditor satisfies himself as to the fairness of the statements "by methods and to the extent he deems appropriate," in general conformity with the auditing procedures recommended in the Institute's bulletin *Examination of Financial Statements*. Ordinarily, if he has so satisfied himself, he is in a position to express an unqualified opinion. However, if he considers it in the interest of clear disclosure of material fact to include explanations of procedures followed, he is free to do so. If, on the other hand, such disclosures are made by reason of any reservation or desire to qualify the opinion, they become exceptions and should be expressly stated as such in the opinion paragraph of the auditor's report. As previously stated, if such exceptions are sufficiently material to negative the expression of an opinion, the auditor should refrain from giving any

opinion at all, although he may render an informative report in which he states that the limitations or exceptions relating to the examination are such as to make it impossible for him to express an opinion as to the fairness of the financial statements as a whole.

It is desirable as a general rule that exceptions by the independent certified public accountant be included in a paragraph separate from all others in the report and be referred to specifically in the final paragraph in which the opinion is stated. Any exception should be expressed clearly and unequivocally as to whether it affects the scope of the work, any particular item of the financial statements, the soundness of the company's procedures (as regards either the books or the financial statements) or the consistency of accounting practices where lack of consistency calls for exception.

It is the responsibility of the accountant—and one which he cannot escape—to determine the scope of the examination which he should make before giving his opinion on the statements under review. If in his judgment it is not practicable and reasonable in the circumstances of a given engagement to undertake the auditing procedures regarding inventories and/or receivables set forth in this report as generally accepted procedure and he has satisfied himself by other methods regarding such inventories and/or receivables no useful purpose will be served by requiring an explanation in his report. If physical tests of inventories and/or confirmation of receivables are practicable and reasonable and the auditor has omitted such generally accepted auditing procedure, he should make a clear-cut exception in his report.

It is worthy of repetition that the extent of sampling and testing should be based upon the independent auditor's judgment as to the effectiveness of internal control, arrived at as the result of investigations, tests, and inquiries. Depending upon his conclusions in this respect, the independent certified public accountant should extend or may restrict the degree of detailed examination. Consequently in some cases it may be necessary to modify or omit reference to reliance upon the system of internal control. Clearly also where a detailed examination is made, the phrase "without making a detailed audit of the transactions" would be inappropriate.

It is contemplated that, before signing a report of the short-form type suggested, the independent certified public accountant will be satisfied that his examination is in conformity with the procedures and practices outlined in *Examination of Financial Statements*, a bulletin published by the American Institute of Accountants in January, 1936, or in any subsequent revision thereof.

The report should be addressed to the board of directors or the stockholders if the appointment is made by them.

The description of the financial statements in both paragraphs should, of course, conform to the titles of the accompanying statements.

In consideration of the foregoing remarks the following short form of report is recommended:

Short Form of Independent Certified Public Accountant's Report or Opinion

To the Board of Directors (or Stockholders) of the XYZ Company:

We have examined the balance-sheet of the XYZ Company as of April 30, 1939, and the statements of income and surplus for the fiscal year then ended, have reviewed the system of internal control and the accounting procedures of the company and, without making a detailed audit of the transactions, have examined or tested accounting records of the company and other supporting evidence, by methods and to the extent we deemed appropriate.

In our opinion, the accompanying balance-sheet and related statements of income and surplus present fairly the position of the XYZ Company at April 30, 1939, and the results of its operations for the fiscal year, in conformity with generally accepted accounting principles applied on a basis consistent with that of the preceding year.

It is worthy of repetition and emphasis that while the proposed form is submitted as a standard, it is not prescribed or recommended for invariable use but should be adapted to the needs of the particular case.

As of March 1, 1941, the Securities and Exchange Commission has revised Rules 2-02 and 3-07 of Regulation S-X, which governs the form and content of all financial statements required to be filed with it, so that they now read as follows:

Rule 2-02. Accountants' Certificates

(*a*) *Technical requirements.*—The accountant's certificate shall be dated, shall be signed manually, and shall identify without detailed enumeration the financial statements covered by the certificate.

(*b*) *Representations as to the audit.*—The accountant's certificate (i) shall contain a reasonably comprehensive statement as to the scope of the audit made including, if with respect to significant items in the financial statements any auditing procedures generally recognized as normal have been omitted, a specific designation of such procedures and of the reasons for their omission; (ii) shall state whether the audit was made in accordance with generally accepted auditing standards applicable in the circumstances; and (iii) shall state whether the audit made omitted any procedure deemed necessary by the accountant under the circumstances of the particular case.

In determining the scope of the audit necessary, appropriate consideration shall be given to the adequacy of the system of internal check and control. Due weight may be given to an internal system of audit regularly maintained by means of auditors employed on the registrant's own staff. The accountant shall review the accounting procedures followed by the person or persons whose statements are certified and by appropriate measures shall satisfy himself that such accounting procedures are in fact being followed.

Nothing in this rule shall be construed to imply authority for the omission of any procedure which independent accountants would ordinarily employ in the course of an audit made for the purpose of expressing the opinions required by paragraph (*c*) of this rule.

(*c*) *Opinions to be expressed.*—The accountant's certificate shall state clearly:

(i) the opinion of the accountant in respect of the financial statements covered by the certificate and the accounting principles and practices reflected therein;
(ii) the opinion of the accountant as to any changes in accounting principles or practices, or adjustments of the accounts, required to be set forth by Rule 3-07; and
(iii) the nature of, and the opinion of the accountant as to, any significant differences between the accounting principles and practices reflected in the financial statements and those reflected in the accounts after the entry of adjustments for the period under review.

(*d*) *Exceptions.*—Any matters to which the accountant takes exception shall be clearly identified, the exception thereto specifically and clearly stated, and, to the extent practicable, the effect of each such exception on the related financial statements given.

RULE 3-07. CHANGES IN ACCOUNTING PRINCIPLES AND PRACTICES

If any significant change in accounting principle or practice, or any significant retroactive adjustment of the accounts of prior years, has been made at the beginning of or during any period covered by the profit and loss statements filed, a statement thereof shall be given in a note to the appropriate statement, and, if the change or adjustment substantially affects proper comparison with the preceding fiscal period, the necessary explanation.

In the opinion of the Committee on Auditing Procedure of the American Institute of Accountants (see "Statements on Auditing Procedure," No. 5, February, 1941), a certificate would be acceptable to the Commission in the normal case if it takes the following form:

We have examined the balance-sheet of the XYZ Company as of February 28, 1941, and the statements of income and surplus for the fiscal year then ended, have reviewed the system of internal control and the accounting procedures of the company and, without making a detailed audit of the transactions, have examined or tested accounting records of the company and other supporting evidence, by methods and to the extent we deemed appropriate. Our examination was made in accordance with generally accepted auditing standards applicable in the circumstances and included all procedures which we consider necessary.

In our opinion, the accompanying balance-sheet and related statements of income and surplus present fairly the position of the XYZ Company at February 28, 1941, and the results of its operations for the fiscal year, in conformity with generally accepted accounting principles applied on a basis consistent with that of the preceding year.

These S.E.C. requirements may be adopted in the future by the profession for reports other than those to the S.E.C.

Longer certificates are likely to contain so much detail and so many qualifications that no clear idea of what the auditors' opinions really are can be obtained. A limited number of qualifications may be made in a certificate without detracting from the importance of the opinions expressed; when the opinions become insignificant details in a maze of qualifications and conditions, they are probably better unexpressed.

Certificates are usually dated and addressed to the stockholders, directors, or an official of the client. They should be directed to those who appoint the public accountant. The pamphlet referred to on page 124 has the following interesting comments:

APPOINTMENT OF INDEPENDENT CERTIFIED PUBLIC ACCOUNTANTS

Apart from the specific phases of auditing procedure which have been the subject of consideration, the method of appointment of the independent auditor and his status in relation to the client are believed to be subjects of great importance to stockholders and creditors.

To emphasize the auditor's independence of the management, some corporations affected by public interest have adopted the practice of having the independent auditor engaged or nominated by the board of directors or elected annually by the stockholders. Other corporations have provided that the stockholders be given an opportunity to ratify the selection made by the directors.

It is suggested that the auditor should be appointed early in each fiscal year so that he may carry out part of his work during the year.

As a result of the McKesson & Robbins, Inc., investigation, the S.E.C. has recommended in its "Summary of Findings and Conclusions," Accounting Release No. 19, the following specific program:

1. Election of the auditors for the current year by a vote of the stockholders at the annual meeting followed immediately by notice to the auditors of their appointment.

2. Establishment of a committee to be selected from non-officer members of the board of directors which shall make all company or management nominations of auditors and shall be charged with the duty of arranging the details of the engagement.

3. The certificate (sometimes called short-form report or opinion) should be addressed to the stockholders. All other reports should be addressed to the board of directors, and copies delivered by the auditors to each member of the board.

4. The auditors should be required to attend meetings of the stockholders at which their report is presented to answer questions thereon, to state whether or not they have been given all the information and access to all the books and records which they have required, and to have the right to make any statement or explanation they desire with respect to the accounts.

5. If for any reason the auditors do not complete the engagement and render a report thereon, they shall, nevertheless, render a report on the amount of work they have done and the reasons for noncompletion, which report should be sent by the company to all stockholders.

When certificates are to appear in reports to stockholders, they are prepared for general use and the auditor cannot adapt them to the particular needs of certain persons. He must, therefore, consider carefully the effect that they may have on any person who may happen to see them. Even though statements are supposed to be for the private use of specified individuals, the auditor never knows when others may have access to them, and he must word them accordingly. He should strive to make them particularly useful to those for whom they are especially prepared and helpful to any others who may happen to examine them. In framing a certificate the auditor has not much freedom for the exercise of his individual style; he is forced to use the more or less stereotyped forms of expression in general use. Because his report is short, he should read and study it several times before its release. It is sometimes good practice for him to lay it aside when presumably finished and return later to see whether it still appears to be acceptable. The certificate may be included as part of a longer report, it may be attached to one of the statements, or it may be a separate document referring to specific statements. The auditor must consider whether the reader of the certificate will always know definitely to what statements the auditor's opinions refer.

CONCLUSION

It must be constantly remembered that reports and certificates are the results into which the audit work flowers. They are the tangible outgrowths of technical procedure, which clients and others see and examine. From them the readers judge the

businesses concerning which the auditor's opinions are expressed and the work that the auditor has performed. Continued improvement in their content and form is evident today. The young accountant will do well to endeavor to master the difficult art of report writing.

QUESTIONS

1. What is an audit report?
2. How can the working papers be of aid in preparing the report?
3. Of what value is the prompt preparation of the report?
4. Where should the report be prepared?
5. Who should write the report?
6. What is the work of the report department?
7. How are reports sent to clients?
8. Why should the contents of reports be expressed simply and clearly?
9. Of what use is a table of contents?
10. What is the purpose of the introduction?
11. What should the section of comments contain?
12. Why should the auditor attempt to be more than a business historian?
13. Where should the statements be placed in the report?
14. What is a certificate?
15. What difficulties has the profession encountered in the use of a certificate?
16. How long are typical certificates today?
17. What major changes in the content of certificates have been recommended recently by the American Institute of Accountants?
18. What rules have been promulgated by the S.E.C., governing certificates?
19. To whom should certificates be addressed?
20. What do the Institute and the S.E.C. recommend in connection with the appointment of auditors?
21. Why is the content and form of reports and certificates of such great importance?

CASES

PART 1

INTRODUCTORY

CHAPTER I

PURPOSES AND SCOPE OF AUDITING

1. THE SOCIETY OF CERTIFIED PUBLIC ACCOUNTANTS OF THE STATE OF NEW JERSEY

CLASSIFICATION OF ACCOUNTANCY SERVICES: WHAT CONSTITUTES THE WORK OF AUDITORS AND PUBLIC ACCOUNTANTS?

The following tentative classification of accountancy services was issued as a bulletin by The Society of Certified Public Accountants of the State of New Jersey in 1932:

The first five sections below relate to classes of service in which audit and examination procedures are the essential characteristics. Such services constitute the major part of accountancy practice. Sections 6 to 12 contain information dealing in a more general way with a variety of services which may be rendered.

Auditing, as used in a professional sense, may be defined as the procedure whereby one undertakes to pass judgment on the correctness of financial statements and accounts, by scrutinizing accounts, vouchers, documents, and other supporting records and data, corresponding, if necessary, with independent third parties, and orally questioning officials and employes.

Auditing procedure may be used in connection with financial balances at the end of a given period and the financial transactions for the period, which culminate in those balances; or it may be used in connection only with the balances at the end of a period.

The term "transactions," as used herein, is intended to mean any changes affecting the accounts during a period. Accounts relating to income, expense, profits, and losses will be referred to as "operating accounts," the transactions relating thereto as "operations," and those relating to cash receipts and disbursements as "cash transactions."

A report usually is submitted at the conclusion of an audit or examination. A report presents the accountant's findings and conclusions, and may contain an expression of the accountant's opinion in a formal statement commonly known as a certificate, either as part of the report itself or appended to the financial statements.

It is to be understood that except for such current assets as cash, notes and accounts receivable, inventories, etc., the assets shown on the balance sheet of a going concern usually are not stated at realizable values, but at cost or cost less reasonable depreciation in accordance

with recognized principles of accounting. Any departure from the usual accounting basis for the statement of assets should be clearly indicated in the financial statements or in the accountant's certificate.

While the engagements which constitute the major part of accountancy practice probably will fall into the first four classes suggested, it must be recognized that there will be instances in which the wishes of clients will dictate specifications of service which may overlap the clean-cut lines which have been set up to distinguish one type of service from others. It should be obvious, of course, that any suggestions for the guidance of practitioners in arranging undertakings with clients cannot be permitted to interfere with the free operation of a client's wishes with respect to the service to be performed.

I. *Detailed Audit.*—A detailed audit, sometimes referred to as a complete audit, has as its purpose the determination of the correctness of the assets, liabilities (actual and contingent), reserves, capital, and surplus as at a balance sheet date and of all transactions for a period ended on the balance sheet date.

The audit report, addressed to the client, may take the form of a balance sheet, and a statement or statements of income and surplus for the period, together with comments in which a certificate may be incorporated. The certificate may be appended to the financial statements, provided that any essential qualifications are incorporated in the certificate.

II. *General Audit.*—A general audit has as its purpose the determination of the correctness of the assets, liabilities (actual and contingent), reserves, capital, and surplus as at a balance sheet date, and selective audit tests of the transactions for a period ended on the balance sheet date. The character and extent of the tests will be governed by the effectiveness of the system of internal control as determined by the auditor, although such tests will not necessarily disclose every irregularity.

The audit report, addressed to the client, may take the form of a balance sheet, and a statement or statements of income and surplus for the period, together with comments in which a certificate may be incorporated. The certificate may be appended to the financial statements, provided that any essential qualifications are incorporated in the certificate.

III. *Examination of Financial Condition and Review of Operations.*—An examination of financial condition and review of operations, while applicable to engagements other than those involving financing, arises frequently in connection with the proposed issuance of securities, as in financings, mergers, consolidations, reorganizations, etc. This type of service has as its purpose the determination of the correctness of the stated assets, liabilities (actual and contingent), reserves, capital, and surplus as at a balance sheet date, together with analytical review, comparison, investigation, statistical and other tests of the income, expense, profits and losses for a period (usually three to five years) ended on the balance sheet date.

The particular object of this type of service is to substantiate the representations made by or in behalf of the organization under examination, with a view to determining that from an accounting standpoint, there is no overstatement of net assets at the balance sheet date nor of net profits for any accounting period under review; that, from an accounting standpoint, the net assets and net profits are at least as great in amount as represented. This particular type of service is not designed to detect lapses of integrity or any understatement of assets which may have been concealed in the operating accounts; it is distinguished from a general audit by omission of the audit of cash transactions, and by substituting analytical study, comparison, investigation, statistical and other tests of the income, expense, profits and losses for selective audit tests of the transactions reflected in those accounts.

The report on an examination of financial condition and review of operations, addressed to the client, usually contains a balance sheet, a statement or statements of income and surplus, a certificate, and, when used in connection with the issuance of securities, usually contains statistical and other explanatory data which will be of assistance in interpreting the financial history and status of the company under review. Such report frequently is supplemented by a statement, or statements, duly certified, giving effect to financial transactions consummated, or to be consummated, subsequent to the date of the balance sheet. Transactions to which effect is given in the supplementary statements should be adequately confirmed.

IV. *Examination of Financial Condition.*—An examination of financial condition has as its purpose the determination of the correctness of the stated assets, liabilities (actual and contingent), reserves, and capital at a balance sheet date, and an analysis of surplus, including as an incident to the substantiation of the balance sheet accounts, examination of such transactions at or about the balance sheet date as may affect the stated financial condition.

This type of service, while requiring examination of the records with a view to substantiating the assets as stated and affording reasonable assurance that there are no liabilities (actual or contingent) other than those stated, does not include audit of cash transactions, such as is required in a general audit, or review of the income, expense, profits and losses, as is required in an examination of financial condition and review of operations, and may not be relied upon to disclose lapses of integrity or any understatement of assets which may have been concealed in the operating accounts.

A report on an examination of financial condition, addressed to the client, may contain properly a certified balance sheet, but if a statement of income and surplus is included in the report, it should be qualified as having been prepared from the books without audit of the transactions for the period.

V. *Audit of Specific Accounts.*—This class of service may cover any particular account, or accounts, of which the following are examples:

(*a*) Cash
(*b*) Securities
(*c*) Payroll
(*d*) Manufacturing cost

An audit report on an account, or accounts, falling in this group, may take the form of a statement of the account or accounts audited, together with comments in which a certificate may be incorporated, or the certificate may be appended to the statement, provided that any essential qualifications are made a part thereof.

VI. *Investigations.*—Investigations comprehend examinations of one or more specific features of a business and are undertaken usually in connection with such matters as:

(*a*) Suspected fraud
(*b*) Disputes regarding payments of royalties, etc.
(*c*) Reasons for increases or decreases of profits
(*d*) Financial policies
(*e*) Determination of amount of civil liability
(*f*) Measurement of contract obligations
(*g*) Insolvency and bankruptcy
(*h*) Measurement of rate-making factors of utilities and carriers, and other financial or administrative matters

In each case the accountant's instructions from his client should be specific as to the object of the investigation.

The scope of each investigation is determined by its objects and the extent to which the accountant considers it necessary to go in order to accomplish those objects.

The accountant's findings in an investigation usually are communicated to his client in the form of a detailed report.

VII. *Tax Services.*—Tax Services may consist of:

Preparing or reviewing tax returns:
(*a*) From records which have been audited.
(*b*) From records which have not been audited.
Contesting assessments or prosecuting tax claims before tax officials or boards.
Preparing and rendering opinions on tax claims.
Acting as adviser or agent in tax matters.

VIII. *System Services.*—System services may cover:

(*a*) General accounting systems:
Conducting surveys.
Devising and installing systems of account and record.
(*b*) Cost systems:
Conducting surveys.
Devising and installing cost-finding, reporting, and standard cost systems.

(*c*) Bonus and profit-sharing systems:
Conducting surveys.
Devising and installing systems.

IX. *Budgetary Services.*—Budgetary services may consist of investigation and survey work, formulating budget policies, designing budget procedures, and offering counsel with reference to budget policies and procedures.

X. *Opinions.*—This class of service consists of preparing and rendering opinions having to do with accounting and financial matters.

XI. *Preparation of Statements from Books or Records without Audit.*—Statements prepared from the books or records without audit should be made preferably on unwatermarked paper, bound (if at all) in a plain back, without any indication in the statements themselves or in anything attached to the statements that they were prepared by public accountants. If, on the other hand, watermarked or regular stationery is used, a footnote should be added to balance sheet or other statements showing that they have been prepared from the general books of account without audit.

In cases where it is necessary to include in a report any statements which have been prepared from the general books without audit, or only partial audit, such statements should be marked under the descriptive heading and at the bottom, so as clearly to indicate that they were prepared from the general books without audit or with only such audit as is indicated opposite the respective items, depending on the situation.

XII. *Miscellaneous.*—This class includes services not comprehended in the foregoing classes, such as:

(*a*) Acting as liquidating trustee
(*b*) Acting as advocate in the arbitration of commercial disputes
(*c*) Acting as arbitrator in commercial disputes
(*d*) Acting as umpire in accounting controversies involving accountants, or clients
(*e*) Acting as comptroller, auditor, or bookkeeper
(*f*) Giving testimony in court and arbitration cases
(*g*) Interpreting financial data
(*h*) Rendering advice in accounting matters
(*i*) Preparing and recording bookkeeping entries, instructing bookkeepers, and checking statements, etc.

Sections 6 to 12, inclusive, should not be considered as definitive or restrictive, but as containing general information only of various activities which are considered to fall within the field of the public accountant.

Miscellaneous activities in the nature of research, verification or constructive work should be designated in each case with an accurate description of the work undertaken.

Consider critically the scope of the work involved in each type of engagement.

2. FIRST NATIONAL STORES, INC.

AUDIT SCOPE: WHAT FACTORS DETERMINE THE SCOPE OF A PARTICULAR AUDIT?

First National Stores, Inc., was organized in 1926 when four chains were merged, each of which was operating grocery stores in the New England territory. Additional chains of stores were acquired in subsequent years, and by March 31, 1934, the company had 2,653 retail stores, of which 2,233 were grocery stores and 420 were combination grocery, fruit, vegetable, and meat stores. The company manufactured a large number of products under its own brands, and, through its four distribution bases in Somerville, Massachusetts, Providence, Rhode Island, and Hartford and Bridgeport, Connecticut, distributed its products to the retail stores. The main base at Somerville contained the following:

General and executive offices
Grocery warehouse
Grocery shipping department
Meat warehouse
Meat shipping department
Produce warehouse
Produce shipping department
Manufacturing department for grocery products
Manufacturing department for meat products
Beverage manufacturing plant
Bread bakery
Cake bakery
Laundry
Printing plant
Reclamation or salvage shed

Bread bakeries were maintained in connection with the distribution bases at Hartford and Providence. The company also owned and operated creamery stations in the Middle West.

For administrative purposes there were four operating divisions, each with headquarters at a distribution base. The divisions were further broken into districts, five of which were located in the Somerville division and one in each of the other three divisions. Under the district managers there were supervisors, who in turn were in charge of superintendents. It was the duty of each of the latter to oversee the activities of approximately 18 stores.

The superintendents performed the general merchandising functions for the stores in their territories and in addition took physical inventories in the retail stores. Inventories, taken by actual count, were entered on specified forms and sent to the division offices for pricing and extensions.

There were four auditors, working out of the general offices, whose duty it was to make quarterly audits of the divisions, paying particular attention to cash. These auditors, who worked in pairs, audited the books and accounts of the general offices at the Somerville division as well as those of the other three bases.

Merchandising functions were in large measure decentralized. Although some purchasing was done cooperatively through the central office, most of it was handled through the division offices. Incoming cash was concentrated in division bank accounts, from which each division made disbursements for its territory.

The company made it a policy to assimilate newly acquired stores as soon as possible, thereby securing a uniform system of accounts and uniformity of operating methods. A majority of the stores were operated under short term leases with options for renewals. Leases for the grocery stores rarely exceeded one year whereas those on the combination stores averaged a little longer. Although some credit was extended to welfare and other agencies, retail sales were ordinarily made for cash only.

The balance sheet as of March 31, 1934, and the operating statement and reconciliation of surplus for the period then ended, with certification by Price, Waterhouse & Company were as below:

First National Stores, Inc.
Comparative Balance Sheets—March 31, 1934 and April 1, 1933

	March 31, 1934	April 1, 1933	Increase Decrease*
Assets			
Current Assets:			
Cash in banks and on hand (after deducting dividends paid April 2)....	$ 3,043,311.03	$ 2,655,028.75	$ 388,282.28
U. S. Government securities.........	3,782,346.04	2,739,683.07	1,042,662.97
Accounts receivable, less reserve.....	422,603.66	566,025.57	143,421.91*
Accounts receivable, officers and employees..........................	6,486.55	7,655.68	1,169.13*
Inventories of merchandise, materials and supplies, on hand and in transit, at cost or market, whichever lower..	10,624,052.44	8,637,741.55	1,986,310.89
Total Current Assets...........	$17,878,799.72	$14,606,134.62	$3,272,665.10

First National Stores, Inc. (*Continued*)
Comparative Balance Sheets—March 31, 1934 and April 1, 1933

	March 31, 1934	April 1, 1933	Increase Decrease*
Investments, Etc.:			
First National Stores, Inc.:			
Common stock at book value—12,555 shares at March 31, 1934	$ 633,964.58	$ 765,549.38	$ 131,584.80*
First preferred stock at cost—1,392 shares at March 31, 1934	147,748.80	167,532.55	19,783.75*
Pipestone Produce Company—wholly owned creamery subsidiary	142,603.12	167,333.04	24,729.92*
Deposits in closed and restricted banks less reserves	77,590.16	133,847.85	56,257.69*
Miscellaneous securities and advances (including R. E. Cobb Company, partly owned subsidiary)	215,411.00	224,071.99	8,660.99*
Total Investments, etc.	$ 1,217,317.66	$ 1,458,334.81	$ 241,017.15*
Deferred Charges:			
Prepaid insurance and expenses	$ 368,521.98	$ 458,485.48	$ 89,963.50*
Fixed Assets (at cost):			
Land and buildings owned	$ 6,027,704.63	$ 6,019,529.79	$ 8,174.84
Less—Reserve for depreciation	828,487.76	677,414.24	151,073.52
	$ 5,199,216.87	$ 5,342,115.55	$ 142,898.68*
Store fixtures, leased property improvements, machinery and equipment	$10,248,615.24	$10,173,023.01	$ 75,592.23
Automobiles	606,815.62	582,631.40	24,184.22
	$10,855,430.86	$10,755,654.41	$ 99,776.45
Less—Reserve for depreciation	4,481,545.26	3,765,217.57	716,327.69
	$ 6,373,885.60	$ 6,990,436.84	$ 616,551.24*
Total Fixed Assets	$11,573,102.47	$12,332,552.39	$ 759,449.92*
Goodwill	$ 1.00	$ 1.00	....
	$31,037,742.83	$28,855,508.30	$2,182,234.53
Liabilities			
Current Liabilities:			
Acceptances payable under letters of credit	$ 231,152.68	$ 123,470.02	$ 107,682.66
Note payable	....	50,000.00	50,000.00*
Accounts payable and accrued expenses	2,928,535.08	2,834,633.46	93,901.62
Employees' investment certificates	429,790.00	500,875.00	71,085.00*
Provision for federal income taxes	754,477.28	702,435.84	52,041.44
Total Current Liabilities	$ 4,343,955.04	$ 4,211,414.32	$ 132,540.72
Reserves:			
For contingencies	$ 334,600.58	$ 334,600.58	$..........
For sinking fund preferred stocks	1,360,570.00	1,140,570.00	220,000.00
Miscellaneous	168,271.50	137,011.84	31,259.66
Total Reserves	$ 1,863,442.08	$ 1,612,182.42	$ 251,259.66
Capital Stock:			
7% first preferred:			
Authorized and issued or held for exchange for 8% preferred—50,000 shares, par value $100 each	$ 5,000,000.00	$ 5,000,000.00	$..........
Common:			
Authorized—1,000,000 shares without par value			
Issued—827,634 shares	6,977,422.07	6,977,422.07	....
Total Capital Stock	$11,977,422.07	$11,977,422.07	$..........
Earned Surplus	$12,852,923.64	$11,054,489.49	$1,798,434.15
	$31,037,742.83	$28,855,508.30	$2,182,234.53

First National Stores, Inc.
Statement of Earnings—Fiscal Year Ending March 31, 1934

Sales	$105,812,781.10
Less:	
Cost of sales, expenses, etc.	99,513,189.98
	$ 6,299,591.12
Deduct:	
Depreciation on fixed assets	1,154,165.85
	$ 5,145,425.27
Add:	
Interest and dividends received (net)	45,793.14
	$ 5,191,218.41
Deduct:	
Loss on disposition of capital assets, etc.	81,146.37
	$ 5,110,072.04
Deduct:	
Provision for federal income taxes	715,241.54
Net profit for the fiscal year ending March 31, 1934	$ 4,394,830.50

Surplus Account for the Year Ending March 31, 1934

Earned surplus at April 1, 1933			$11,054,489.49
Net profit for the fiscal year ending March 31, 1934		$4,394,830.50	
Less:			
Dividends paid:			
Preferred stock	$ 339,950.10		
Common stock	2,036,446.25	2,376,396.35	
Balance after dividends		$2,018,434.15	
Provision for sinking fund 7 % first preferred stock		220,000.00	
Balance added to surplus			1,798,434.13
Earned surplus at March 31, 1934			$12,852,923.64

To the Stockholders of First National Stores, Inc.:

We have made an examination of the balance sheets of First National Stores, Inc., as at March 31, 1934, and April 1, 1933, and of the statements of earnings and surplus for the fiscal year ending March 31, 1934. In connection therewith, we examined or tested accounting records of the Company and other supporting evidence and obtained information and explanations from officers and employees of the Company; we also made a general review of the accounting methods and of the operating and income accounts for the year but we did not make a detailed audit of all transactions.

In our opinion, based upon such examination, the accompanying balance sheets and related statements of earnings and surplus fairly present, in accordance with accepted principles of accounting, consistently maintained by the Company during the year under review, its position at March 31, 1934, and April 1, 1933, and the results of its operations for the fiscal year ending March 31, 1934.

Boston, Massachusetts
May 23, 1934 PRICE, WATERHOUSE & CO.

Outline your conception of the work done by the auditors before certifying the above statements.

Into which section of the Classification of Accountancy Services of the Society of Certified Public Accountants of the State of New Jersey would this work best fit?

3. AIRCASTLE THEATRE—No. 1

ASCERTAINMENT OF FRAUD: HOW SHOULD AUDITORS CHECK INCOME FROM ADMISSIONS WHERE FRAUD WAS INVOLVED?

The Aircastle Theatre was one of a small group of moving picture theatres, all located in New England and owned by Mr. C. H. Bartram. This one which was the smallest of the group had a seating capacity for about 534 people. Ordinarily, there were two performances each day, one starting at two o'clock in the afternoon and the other at eight o'clock in the evening. On holidays and at other times when the manager felt it desirable there were three shows. Ten cents was the matinee charge except for Saturdays and holidays when it was 15 cents. The evening charge was 25 cents. The tickets, which were of three different colors, one for each price, were in roll form and were consecutively numbered.

The personnel consisted of five people, the manager, a piano player, an operator for the moving picture machine, an assistant operator, and a ticket seller. The manager was always present and helped out where necessary. His main duty during the time of the performances was to keep boys from sneaking in without paying. The assistant operator also acted as the ticket taker until he had to help change machines after the first reel. In the case of all people who came after the assistant operator went upstairs, the ticket seller took the money, but tore off no tickets. When the daily report was made up, enough tickets were torn off to make the difference between the beginning and ending numbers on the ticket rolls agree with the cash.

During 1924, it became necessary to hire a new manager, and Mr. Bartram employed a young man without looking carefully into his references. At that time the wife of the machine operator was working as ticket seller. She occasionally complained to her

husband about being sent by the manager on petty errands during the period when most of the patrons were arriving. On these occasions the manager would sell tickets. This complaint made the operator suspicious of the manager and so he spoke to Mr. Bartram about it. The latter decided to take a secret count of the number of admissions and to compare this with the receipts of cash. Several of these counts came out with a considerable discrepancy. This result confirmed the suspicions of the operator that the manager occasionally sent the assistant operator away from the door to eject some boys in order that he might take the tickets himself and keep them. Later the manager sent the ticket seller away, sold the tickets he had collected, and pocketed the money himself. Accordingly the manager was discharged. Mr. Bartram guarded against any such fraud in the following years by making a practice of visiting the theatre quite frequently, but irregularly, to see that the manager was not selling tickets.

In December, 1927, Mr. Bartram made arrangements with a public accounting firm for the audit of his small group of theatres for the year ended December 31, 1927. In the case of the Aircastle Theatre Mr. Bartram had again become suspicious of fraud. During the fall of 1927 a state inspector of buildings had visited the theatre and had reported to the owner that there were 170 people standing on the night of inspection. The daily report showed only 619 tickets sold for that evening. This number was only 85 over the seating capacity of 534, and though Mr. Bartram realized that some of the seats were very poor and were never occupied, the discrepancy of 85 appeared much too large. Mr. Bartram had also felt on several occasions when he had visited the theatre that the attendance was larger than the cash receipts had shown. The declining tendency of the receipts during the whole of 1927 had so disturbed him that he made several checks on his own account, all of which had come out fairly close.

The auditors knew nothing of the fraud discovered during 1924 or of the suspected fraud in 1927. They were aware only of the fact that the receipts from the Aircastle Theatre had been declining in 1927. Still, as a part of their audit, they believed that certain tests should be made. In determining how much should be done, they first looked into the existing conditions. They found that the capacity of the house, the personnel, and the sell-

ing of tickets were as previously described. The daily reports that were made out and sent to the owner showed the beginning number on each ticket roll, the ending number, and the difference. They also showed the amount of cash received at each performance. This form of report had been used since September, 1927. All these reports had been kept, but all previous ones had been destroyed.

The arrangement of the theatre itself was rather peculiar. The entrance to the theatre was on the second floor of the building. There was an entrance from this second floor landing to the offices on the front of the building. The stairs also continued up to other offices and club rooms on the upper floors. Inside the door of the theatre was a passageway which led to the balcony, while directly ahead was the entrance to the orchestra seats. On each side of the stage were passages through which people could pass from the main floor to the balcony or vice versa. These were entirely separate from the main passage that led from the entrance to the balcony.

The auditors found further that the manager had considerable trouble with boys who got in without paying, by waiting until the lights were turned off at the beginning of the picture. It was the custom, furthermore, to give passes to the individuals who showed posters advertising the various pictures. These passes, however, could not be used on Saturday and holiday nights.

How should the auditors, unaware of fraud, have checked the income from admissions?

Describe the procedure in detail.

Would the procedure you suggest bring to light all possible kinds of fraud?

What type of public accounting practice does this case illustrate?

4. THE YOUNGSTOWN SHEET AND TUBE COMPANY

SPECIAL PURPOSE AUDITS: WHEREIN DO THEY DIFFER FROM THE MORE FAMILIAR BALANCE SHEET AUDIT?

Stockholders of The Youngstown Sheet and Tube Company, feeling that the terms of the proposed merger with the Bethlehem Steel Corporation in 1930 were inequitable, challenged the report of Price, Waterhouse & Company, auditors for the Bethlehem Steel Corporation. Ensuing letters, which are self-explanatory, were as follows:

To the Shareholders of
The Youngstown Sheet and Tube Company:

The report of Messrs. Price, Waterhouse & Company as to a fair basis of exchange of the stock of Bethlehem for shares of Sheet and Tube having been challenged, we asked three other leading firms of accountants to examine into the facts and report whether in their opinion the terms of the merger were fair to Sheet and Tube. Their report, which speaks for itself, is published herewith.

Bethlehem Steel Corporation
The Youngstown Sheet and Tube Company

April 2, 1930

New York, N. Y.,
March 31, 1930

Bethlehem Steel Corporation,
The Youngstown Sheet and Tube Company.

Dear Sirs:

At your request we have considered the terms of the proposed merger between Bethlehem Steel Corporation and The Youngstown Sheet and Tube Company for the purpose of forming an opinion on the question whether the terms of 1⅓ shares of Bethlehem common stock for each share of Sheet and Tube are fair to the shareholders of The Youngstown Sheet and Tube Company.

In considering the questions presented, we have referred to the published annual reports of the two companies for the last five years, and Messrs. Price, Waterhouse & Co. have put at our disposal various tabulations and computations made by them. The accounting officers of Bethlehem have furnished such additional information as seemed to us requisite and have answered all the questions which we have asked. We have also examined the

report addressed by Messrs. Ernst & Ernst to Mr. J. A. Campbell under date of March 24, and various reports which have been issued to the shareholders of Sheet and Tube by a committee opposing the merger.

Our conclusion is that on the basis of relative earnings the proposed terms are fair and favorable to the Sheet and Tube Company.

On the basis of net asset values and on the basis of relative working capital they are even more favorable to the Sheet and Tube shareholders.

. . . .

In arriving at their conclusion the auditors expressed the following beliefs:

1. Relative fixed charges caused no inequity to either party.
2. Bethlehem was contributing relatively more working capital per share.
3. The book value contributed by Bethlehem was relatively higher than Youngstown.
4. After treating the years 1925–1928 and the year 1929 separately the basis of exchange was favorable to Youngstown from the standpoint of relative earning capacity.

The auditors' own words were the following:

Summarizing the foregoing, our conclusions are: first, that on the basis of relative earnings (taking into account the years 1925 to 1929, inclusive, and plant under construction at the end of the year) the basis of exchange is favorable to Sheet and Tube; second, that Bethlehem is contributing working capital to the extent of $40,000,000, or $12.50 per share in excess of its rateable contribution on the agreed basis of merger.

We are convinced, therefore, that the terms of the proposed merger are fair and favorable to Sheet and Tube.

Yours very truly,
HASKINS & SELLS
LYBRAND, ROSS BROS. & MONTGOMERY
ARTHUR ANDERSEN & CO.

What procedure do you believe the auditors followed in order to arrive at each of the above conclusions?

5. PERCHE VALLEY BRIDGE COMPANY

AUDITOR'S REPORT: UNDER WHAT CIRCUMSTANCES MAY AN AUDITOR BE EMPLOYED TO SUBMIT A REPORT?

On June 29, 1926, the Perche Valley Bridge Company was organized, as stated in the company's charter, to buy, lease, acquire, hold, own, erect, construct, maintain, operate, and conduct, either on its own account or as agent for any other party or parties, bridges, trestles, causeways, subways, elevated or surface ways, roads, and highways; to engage in a general trading business in both real and personal property; and to perform any and all acts necessary or advantageous to the conduct of its business. To acquire sufficient capital to operate the business a large bond issue had been floated, the fixed charges upon which, along with poor business and small profits, soon caused difficulty.

By the latter part of 1926 the bondholders had become dissatisfied with the management and its results, and decided to force the company into receivership, with a receiver whom they had recommended. At the same time the bondholders requested the board of directors and the stockholders to have an audit made, so that it would be clear to everyone interested just what the receiver was taking over and what his responsibilities were. A firm of auditors was employed to examine the books of the Perche Valley Bridge Company and submitted the following report upon its findings:

February 17, 1927

Board of Directors and Stockholders,
Perche Valley Bridge Company,
Midway, Missouri.

Gentlemen:

We have completed our examination of the books of account and record of PERCHE VALLEY BRIDGE COMPANY, MIDWAY, MISSOURI, for the period from July 1, 1926, to December 31, 1926, and submit herewith our report, consisting of Balance Sheet, Statement of Income and Expense and supporting schedules.

The Company was organized June 29, 1926, under the laws of the State of Missouri, with an authorized Capitalization of 30,000 shares of Common Stock of no par value. Under its charter the Company is empowered to buy, lease, acquire, hold, own, erect,

construct, maintain, operate and conduct, either on its own account or as agent for any other party or parties, bridges, trestles, causeways, subways, elevated or surface ways, roads and highways, to engage in a general trading business in both real and personal property, and to perform any and all acts necessary or advantageous to the conduct of its business. The authorized existence under its charter is perpetual.

The Assets and Liabilities of the Company at the close of business December 31, 1926, are set forth in the accompanying Balance Sheet, our comments relative thereto being as follows:

Cash on Hand was verified by actual count on February 4, 1927, and reconciled with the amount shown by the books at December 31, 1926. Cash on Deposit was verified by reconcilement of the amount shown in this Balance Sheet with the balance reported to us by the depository bank. All recorded Cash receipts were traced directly into the bank account and Cash disbursements through the bank account were verified by an examination of signed and cancelled bank checks and charge slips and other data on file.

Trust Funds were verified by direct correspondence with the Trustee.

Account Receivable represents balance due from the County of Boone under an agreement by which the general public was allowed free use of the Frontier Boulevard for the period from October 9, 1926, to October 29, 1926. This account amounting to $32,688.06 was confirmed by direct correspondence.

Inventory of Unsold Real Estate, aggregating $6,754,855.57, is stated at the book value as evidenced by the Company's records. This inventory includes Riparian and Mineral Rights to certain tracts of river bottom land, on either side of the causeway known as the Frontier Boulevard, on which the Company is to construct an island designated in this report as Frontier Island and Lots 4 to 16 inclusive, of Block 1 and Lots 6 to 20 inclusive, of Block 2 fronting on the eastern approach to the Frontier Boulevard, known as South Eighth Street.

Deposits with public service corporation, amounting to $150.00 are shown under the caption Other Assets.

Permanent Assets, aggregating $3,761,449.38, are stated at the depreciated book value as evidenced by the Company's records and include the Approach, Office Furniture and Fixtures and Operating Equipment.

The book values of Unsold Real Estate and the Approach are based on an appraisal, by a Board of Appraisers, dated July 31, 1926.

Under the caption Deferred, we include Unexpired Insurance Premiums and Supplies-Inventory December 31, 1926, which, in our opinion, are proper charges against future operations of the Company.

Under the various liability captions we have included all ascertained liabilities of the Company as of December 31, 1926, disclosed by the records examined or information obtained by us. Note Payable for money borrowed was confirmed to us by the recorded holder, the Bank of Midway, and is due on demand. The interest has been paid to December 31, 1926. Accounts Payable were verified by examination of invoices, engineers' estimates of work completed and other data on file. Under the caption Accrued, we have included the liability of the Company for State and City Taxes and Documentary Stamps. The Affiliated Company account is in agreement with the amount shown on the books of the affiliated company. The First Mortgage 6½% Gold bonds, due July 1, 1946, shown in the Balance Sheet under the caption Bonded Indebtedness, were confirmed to us by the Trustee, the Boone County Trust Company. The Trustee also stated that $73,125.00 had been remitted to Chase National Bank on December 28, 1926, for the payment of interest coupons of that amount due January 1, 1927.

Under the caption Reserves we include, Provision for the Construction of Frontier Island, which is the total estimated cost less expenditures to December 31, 1926; Provision for the Rehabilitation of Frontier Boulevard which is the proceeds of insurance claims for losses, caused by the tornado and flood of October 7, 1926; and the Provision for Contingencies which is to provide for the Company's liability to bondholders for taxes that may be levied and collected from them on account of ownership of bonds of this Company or on income derived from bonds of this Company.

Deferred Income includes the value of Outstanding tickets and the Unearned portion of Receipts from sale of Annual Emblems.

Capital Stock outstanding was verified by a trial balance of the certificate stubs in the stock record book. Your attention is directed to the fact that Documentary Stamps have not been affixed to the certificate stubs. We have provided for this liability under the caption Accrued.

In accordance with our understanding, we have made no independent appraisal of the asset values or the legal status of the same, and the liabilities shown are those reflected by the records examined or developed during the course of our work.

Subject to the foregoing and subject also to the valuations of Real Estate and Approach as shown by the records of the Company, WE HEREBY CERTIFY, that we have examined the books of account and record of the PERCHE VALLEY BRIDGE COMPANY, MIDWAY, MISSOURI, for the period from the commencement of business on or about July 1, 1926, to the close of business December 31, 1926, and, that in our opinion, based upon the records

examined and information obtained by us, the accompanying Balance Sheet is drawn up to correctly set forth the financial position of the Company at the close of business December 31, 1926.

Very truly yours,

SEAL WOOD & ROBINSON

STATEMENT OF INCOME AND EXPENSE
PERCHE VALLEY BRIDGE COMPANY, MIDWAY, MISSOURI FOR THE PERIOD FROM JULY 1, 1926, TO DECEMBER 31, 1926

Income			
Bridge Tolls			
Automobiles		$107,752.98	
Trucks		26,088.30	
Motorcycles, Bicycles, etc.		5,367.24	
Recovery on Use and Occupancy Policy on account of total suspension of traffic 1¼ days		1,284.24	
Annual Emblems—Portion Earned		1,214.98	$141,707.74
Expense			
Operating			
Salaries—Cashiers and Ticket Takers	$15,547.61		
—Bridge Tenders	6,717.37		
—Executive	3,825.00		
—Watchman	900.00	$ 26,989.98	
Maintenance and Repairs—Roadways		27,948.53	
Lights, Power and Water		1,573.81	
Police Protection, etc.		1,256.85	
Supplies and Miscellaneous		881.73	
Maintenance and Repairs—Drawbridge		318.54	
Maintenance and Repairs—Autos and Motorcycles		395.95	59,365.39
			$ 82,342.35
Administrative and General			
Depreciation		$ 17,839.59	
Taxes		14,319.72	
Insurance and Fidelity Bonds		3,882.09	
Office Rent and Bookkeeping		2,475.00	
Salaries—Clerical		1,800.00	
Stationery and Printing		573.32	
Advertising		63.00	
Postage, Telephone and Telegraph		39.85	
Abstracts and Recording		38.18	
Miscellaneous Expense		120.15	41,150.90
			$ 41,191.45
Other Deductions			
Interest Paid	$73,257.84		
Provision for Contingencies	4,387.50		
Trustee Fees	2,625.00		
Organization Expense	1,200.00	$ 81,470.34	
Other Income			
Interest Earned		5,317.18	76,153.16
Net Loss			$ 34,961.71*

* Figures in red.

BALANCE

PERCHE VALLEY BRIDGE COMPANY, MIDWAY, MISSOURI

ASSETS				
Cash				
On Hand..................................			$ 300.00	
On Deposit..................................			15,991.17	$ 16,291.17
Trust Funds				
For Construction of Frontier Island...........			$ 371,685.95	
For Rehabilitation of Frontier Boulevard.....			309,734.49	681,420.44
Account Receivable				
County of Boone..........................				32,688.06
Inventory—Unsold Real Estate (Appraised Value)				
Frontier Island (To be built).................			$5,227,500.00	
Lots—Frontier Boulevard Approach..........			1,527,355.57	6,754,855.57
Other				
Meter Deposits				150.00
Permanent				
Approach (Appraised Value)		$3,786,894.61		
Less: Allowance for Depreciation		39,836.17	$3,747,058.44	
Office Furniture and Fixtures	$6,991.23			
Operating Equipment	8,535.57	$ 15,526.80		
Less: Allowance for Depreciation		1,135.86	14,390,94	3,761,449.38
Deferred				
Unexpired Insurance Premiums...............			$ 2,573.40	
Supplies—Inventory December 31, 1926.......			870.00	3,443.40
				$11,250,298.02

NOTE A. No provision has been made for Federal Income Taxes, if any. This Balance Sheet is therefore subject to any necessary adjustment upon determination of the final liability of the company therefor.

SHEET
AT THE CLOSE OF BUSINESS DECEMBER 31, 1926

LIABILITIES			
Note Payable			
For Money Borrowed........................			$ 13,500.00
Accounts Payable			
For Expenses, Repairs, etc...................$		17,497.66	
For Rehabilitation Purchases.................		13,349.78	30,847.44
Accrued			
State and City Taxes.......................$		12,808.69	
Documentary Stamps		1,500.00	14,308.69
Affiliated Company			12,112.66
Bonded Indebtedness			
First Mortgage 6½% Gold Bonds Due July 1, 1946: Authorized and Issued...............			2,250,000.00
Reserves			
For Construction of Frontier Island...........$		371,685.95	
For Rehabilitation—Frontier Boulevard.......		298,957.36	
For Contingencies		4,387.50	675,030.81
Deferred Income			
Outstanding Tickets ....$		465.00	
Annual Emblems—Unearned Portion.........		574.99	1,039.99
Nominal			
Capital Stock			
Authorized and Outstanding			
30,000 Shares—No Par Value$	750.00		
Capital Surplus.................	8,287,670.14	$8,288,420.14	
Profit and Loss—Deficit............		34,961.71*	8,253,458.43
			$11,250,298.02

NOTE B. This Balance Sheet is subject to the comments contained in our "Introductory Letter" included as a part of this report.

* Figures in red.

STATEMENT OF INCOME AND EXPENSE WITHOUT DEPRECIATION
PERCHE VALLEY BRIDGE COMPANY, MIDWAY, MISSOURI
FOR THE PERIOD FROM JULY 1, 1926, TO DECEMBER 31, 1926

Income			
Bridge Tolls			
Automobiles		$107,752.98	
Trucks		26,088.30	
Motorcycles, Bicycles, etc.		5,367.24	
Recovery on Use and Occupancy Policy on account of total suspension of traffic 1¼ days		1,284.24	
Annual Emblems—Portion Earned		1,214.98	$141,707.74
Expense			
Operating			
Salaries—Cashiers and Ticket Takers	$15,547.61		
—Bridge Tenders	6,717.37		
—Executive	3,825.00		
—Watchman	900.00	$ 26,989.98	
Maintenance and Repairs—Roadways		27,948.53	
Lights, Power and Water		1,573.81	
Police Protection, etc.		1,256.85	
Supplies and Miscellaneous		881.73	
Maintenance and Repairs—Drawbridge		318.54	
Maintenance and Repairs—Autos and Motorcycles		395.95	59,365.39
			$ 82,342.35
Administrative and General			
Taxes		$ 14,319.72	
Insurance and Fidelity Bonds		3,882.09	
Office Rent and Bookkeeping		2,475.00	
Salaries—Clerical		1,800.00	
Stationery and Printing		573.32	
Advertising		63.00	
Postage, Telephone and Telegraph		39.85	
Abstracts and Recording		38.18	
Miscellaneous Expense		120.15	23,311.31
			$ 59,031.04
Other Deductions			
Interest Paid	$73,257.84		
Provision for Contingencies	4,387.50		
Trustee Fees	2,625.00		
Organization Expense	1,200.00	$ 81,470.34	
Other Income			
Interest Earned		5,317.18	76,153.16
Net Loss			$ 17,122.12*

No provision has been made in this statement for depreciation on Approach, Operating Equipment or Furniture and Fixtures.

* Figures in red.

ACCOUNTS PAYABLE
PERCHE VALLEY BRIDGE COMPANY, MIDWAY, MISSOURI
DECEMBER 31, 1926

For Expenses, Repairs, Etc.		
Taylor Garage	$ 75.60	
City of Midway	482.62	
Missouri Power and Light Company	562.71	
Kroger's Stores	34.28	
Herald-Statesman Press, The	38.55	
Midway Stationery Company	21.00	
Simon Construction Company	16,011.75	
Renie Hardware Company	48.60	
Haupt and Elwang, Incorporated	120.00	
National Cash Register Company	55.80	
Midway Printing Company	40.87	
Western Union Telegraph Company	5.88	$17,497.66
For Rehabilitation Purchases		
Concrete Company of Midway	$ 871.13	
Krass Commission Company	15.00	
Woods, Newton T.	667.50	
Simon Construction Company	11,758.80	
Renie Hardware Company	37.35	13,349.78
		$30,847.44

RESERVE FOR COMPLETION—FRONTIER ISLAND
PERCHE VALLEY BRIDGE COMPANY, MIDWAY, MISSOURI
DECEMBER 31, 1926

Reserve for Completion—Frontier Island	$375,000.00
Expenditures to December 31, 1926 Chargeable Against this Reserve	
Engineering	3,314.05
Balance December 31, 1926	$371,685.95

CAPITAL SURPLUS
PERCHE VALLEY BRIDGE COMPANY, MIDWAY, MISSOURI
DECEMBER 31, 1926

Balance July 1, 1926	$8,310,802.59
Deduction	
Appreciation realized through depreciation of Approach	23,132.45
Balance December 31, 1926	$8,287,670.14

Reserve for Rehabilitation—Frontier Boulevard
Perche Valley Bridge Company, Midway, Missouri
December 31, 1926

Reserve for Replacement—Flood and Tornado Losses		$426,216.43
Expenditures and Unpaid Items at December 31, 1926 Chargeable against This Reserve		
Clearing Debris	$ 1,417.04	
Engineering	17,978.28	
Fill	28,505.64	
Landscaping	896.25	
Miscellaneous Charges	1,785.75	
Office Expense	3,852.15	
Railings on Bridges	5,245.21	
Repairs and Extra Labor—Drawbridge	1,899.45	
Repairs—Toll and Bridge Houses	800.97	
Repairs, Lights and Other Electrical Equipment	7,877.93	
Repairs and Resurfacing Roadways	50,949.43	
Rip Rap and Bulkhead	1,760.18	
Signs	4,290.79	127,259.07
Balance December 31, 1926		$298,957.36

Stockholders
Perche Valley Bridge Company, Midway, Missouri
December 31, 1926

The Midway Improvement Company	29,992	Shares
C. B. Rollins	4	Shares
A. G. Spencer	2	Shares
R. B. Price	2	Shares
Total	30,000	Shares

INSURANCE PROTECTION
PERCHE VALLEY BRIDGE COMPANY, MIDWAY, MISSOURI
DECEMBER 31, 1926

All Risks		
Approach and Bridge	$750,000.00	
Less: Reduction by settlement for Tornado and Flood Damage	419,474.10	$330.525.90
Use and Occupancy		
Approach and Bridge	$375,000.00	
Less: Reduction by settlement for Tornado and Flood Damage	8,026.57	336,973.43
Fidelity Bonds		
Employees		18,750.00
Public Liability		
Approach and Bridge		15/30,000.00
Studebaker Touring Car		15/30,000.00
Property Damage		
Studebaker Touring Car		1,500.00
Fire and Theft		
Studebaker Touring Car		1,275.00
Inside Messenger Robbery		
Custodian, 513 S. Eighth Street		9,000.00
Custodian, First Booth, Frontier Boulevard		3,000.00
Custodian, Second Booth, Frontier Boulevard		3,000.00
Outside Messenger Robbery		
Custodian, 513 S. Eighth Street		9,000.00
Custodian, First Booth, Frontier Boulevard		3,000.00
Custodian, Second Booth, Frontier Boulevard		3,000.00
Burglary		
Safe, 513 S. Eighth Street		15,000.00
Surety Bond		
In favor of Boone County, State of Missouri—Guarantee to keep Approach and Bridge in good repair and fit for travel		15,000.00

Wherein does this report give the bondholders information desired that a financial statement drawn up by the company's accountant would not have given?

Is the report as complete as it should have been under the circumstances?

What further investigation, if any, might have been made?

CHAPTER II

RESPONSIBILITIES OF AUDITORS

6. LONDON & GENERAL BANK, LTD.[1]

RESPONSIBILITIES OF AUDITORS: HOW THOROUGH MUST AN AUDITOR'S EXAMINATION BE IN ORDER THAT HE MAY SAFELY CERTIFY A STATEMENT?

. . . Lindley, L. J., in hearing the appeal, gave in part the following opinion:

. . . It is impossible to read s. 7 of the Companies Act, 1879, without being struck with the importance of the enactment that the auditors are to be appointed by the shareholders, and are to report to them directly, and not to or through the directors. The object of this enactment is obvious. It evidently is to secure to the shareholders independent and reliable information respecting the true financial position of the company at the time of the audit. The articles of this particular company are even more explicit on this point than the statute itself, and remove any possible ambiguity to which the language of the statute taken alone may be open if very narrowly criticised. It is no part of an auditor's duty to give advice, either to directors or shareholders, as to what they ought to do. An auditor has nothing to do with the prudence or imprudence of making loans with or without security. It is nothing to him whether the business of a company is being conducted prudently or imprudently, profitably or unprofitably. It is nothing to him whether dividends are properly or improperly declared, provided he discharges his own duty to the shareholders. His business is to ascertain and state the true financial position of the company at the time of the audit, and his duty is confined to that. But then comes the question, how is he to ascertain that position? The answer is, by examining the books of the company. But he does not discharge his duty by doing this without inquiry and without taking any trouble to see that the books themselves show the company's true position. He must take reasonable care to ascertain that they do so. Unless he does this his audit would be worse than an idle farce. Assuming the books to be so kept as to show the true position of a company, the auditor has to frame a balance sheet showing that position according to the books and to certify that the balance sheet presented is correct in that sense. But his first duty is to examine the books, not merely

[1] Adapted from *In re London & General Bank*, 2 Ch. 166 (1895) and *In re London & General Bank*, 2 Ch. 673 (1895).

for the purpose of ascertaining what they do show, but also for the purpose of satisfying himself that they show the true financial position of the company. This is quite in accordance with the decision of Stirling J. in *Leeds Estate, Building and Investment Co.* v. *Shepherd.*[1] An auditor, however, is not bound to do more than exercise reasonable care and skill in making inquiries and investigations. He is not an insurer; he does not guarantee that the books do correctly show the true position of the company's affairs; he does not even guarantee that his balance sheet is accurate according to the books of the company. If he did, he would be responsible for error on his part, even if he were himself deceived without any want of reasonable care on his part, say, by the fraudulent concealment of a book from him. His obligation is not so onerous as this. Such I take to be the duty of the auditor; he must be honest—*i.e.*, he must not certify what he does not believe to be true, and he must take reasonable care and skill before he believes that what he certifies is true. What is reasonable care in any particular case must depend upon the circumstances of that case. Where there is nothing to excite suspicion very little inquiry will be reasonably sufficient, and in practice I believe business men select a few cases at haphazard, see that they are right, and assume that others like them are correct also. Where suspicion is aroused more care is obviously necessary; but, still, an auditor is not bound to exercise more than reasonable care and skill, even in a case of suspicion, and he is perfectly justified in acting on the opinion of an expert where special knowledge is required.

State in your own words your conception of the auditor's duties.

7. ULTRA MARES CORPORATION[2]

RESPONSIBILITY OF AUDITORS: WHAT RESPONSIBILITY DOES AN AUDITOR ASSUME IN CERTIFYING A BALANCE SHEET?

In January, 1924, members of the firm of Touche, Niven & Company, public accountants, were employed by the president of Fred Stern & Company, Inc., rubber importers, to prepare and certify a balance sheet for the company as of December 31, 1923. The accountants had performed this service at the end of each of the three preceding years.

[1] 36 Ch. D. 787 (1887).
[2] *Ultra Mares Corporation* v. *Touche et al.* [255 N. Y. 88, 174 N. E. 441 (1931)].

When the audit was completed, the balance sheet prepared showed assets of $2,550,671.88, liabilities, secured and unsecured, of $1,479,956.62, contingent liabilities of $909,482.28 and capital stock and surplus of $1,070,715.26. The certificate attached to the balance sheet read as follows:

TOUCHE, NIVEN & COMPANY
PUBLIC ACCOUNTANTS
EIGHTY MAIDEN LANE
NEW YORK

February 26, 1924

CERTIFICATE OF AUDITORS

We have examined the accounts of Fred Stern & Co., Inc., for the year ended December 31, 1923, and hereby certify that the annexed balance sheet is in accordance therewith and with the information and explanation given us. We further certify that, subject to provisions for federal taxes on income, the said statement, in our opinion, presents a true and correct view of the financial condition of Fred Stern & Co., Inc., as at December 31, 1923.

TOUCHE, NIVEN & CO.
PUBLIC ACCOUNTANTS

Eight counterparts of the certified balance sheet were delivered to Fred Stern & Company at the conclusion of the audit and twenty-four more were furnished later on. The accountants were not informed as to the persons to whom these counterparts would be shown or the extent or number of the transactions in which they would be used. The accountants were occupied over 300 hours in the audit and were paid $1,138 to cover services and disbursements.

It was the practice of Fred Stern & Company to borrow large sums from banks and other lenders in order to finance its operations. In April, 1924, the company's president approached the Ultra Mares Corporation, which had never before advanced money to Fred Stern & Company, in regard to a loan and submitted, on being requested to do so, one of the counterparts of the balance sheet and certificate prepared by Touche, Niven & Company. Beginning April 5, 1924, and continuing until December 23, 1924, various loans aggregating without interest, $2,343,818, were made by the Ultra Mares Corporation to Fred Stern & Company. All the loans were paid except the last four

and a part of the one preceding. The unpaid loans with interest amounted to $250,237.40 on April 1, 1929. All loans made by the Ultra Mares Corporation were, by agreement, to be secured by assignments of accounts receivable, which accounts were to be assigned as soon as the rubber, which was the basis of the loans, had been actually received by Fred Stern & Company from steamer or warehouse and shipped to customers, at which time the customers would be notified of such shipments and of the assignments by Fred Stern & Company to the Ultra Mares Corporation of the accounts with the customers to secure the loans. The conditions of the agreement were fulfilled with respect to the earlier loans, but later the lending corporation did not insist upon the prompt assignment of the accounts and, in particular, failed to require the assignment of accounts in support of the loans which were not paid.

On January 2, 1925, Fred Stern & Company was declared a bankrupt. In November, 1926, the Ultra Mares Corporation brought suit against the firm of Touche, Niven & Company to recover the amounts which had not been repaid. The plaintiff stated that the loans had been made on the basis of the statement prepared by the accountants, which showed Fred Stern & Company to be a going concern with assets greatly in excess of liabilities. It maintained that if the audit had been carefully made, the balance sheet would have shown the company to be insolvent on the date of the balance sheet. The action brought against the accountants originally was for negligence, but later a second cause of action asserting fraud was added.

The following summary of certain evidence introduced at the trial was made by one of the judges before whom the case was later tried to support his belief that the audit had been negligently performed:

We begin with the item of accounts receivable. At the start of the defendant's audit, there had been no posting of the general ledger since April, 1923. Siess, a junior accountant, was assigned by the defendants to the performance of that work. On Sunday, February 3, 1924, he had finished the task of posting, and was ready the next day to begin with his associates the preparation of the balance sheet and the audit of its items. The total of the accounts receivable from December, 1923, as thus posted by Siess from the entries in the journal was $644,758.17. At some time on February 3, Romberg, an employee of the Stern Company, who had general charge of its accounts, placed below that total

another item to represent additional accounts receivable growing out of the transactions of the month. This new item, $706,843.07, Romberg entered in his own handwriting. The sales that it represented were, each and all fictitious. Opposite the entry were placed other figures (12-29), indicating or supposed to indicate, a reference to the journal. Siess, when he resumed his work, saw the entries thus added, and included the new item in making up his footings, with the result of an apparent increase of over $700,000 in the assets of the business. He says that in doing this he supposed the entries to be correct, and that his task at the moment being merely to post the books, he thought the work of audit or verification might come later, and put it off accordingly. The time sheets, which are in evidence, show very clearly that this was the order of time in which the parts of the work were done. Verification, however, there never was either by Siess or by his superiors, or so the triers of the facts might say. If any had been attempted, or any that was adequate, an examiner would have found that the entry in the ledger was not supported by an entry in the journal. If from the journal he had gone to the book from which the journal was made up, described as "the debit memo book," support would still have failed. Going farther, he would have found invoices, seventeen in number, which amounted in the aggregate to the interpolated item, but scrutiny of these invoices would have disclosed suspicious features in that they had no shipping number nor a customer's order number and varied in terms of credit and in other respects from those usual in the business. A mere glance reveals the difference.

The December entry of accounts receivable was not the only item that a careful and skillful auditor would have desired to investigate. There was ground for suspicion as to an item of $113,119.60, included in the accounts payable as due from the Baltic Corporation. As to this the defendants received an explanation, not very convincing, from Stern and Romberg. A cautious auditor might have been dissatisfied and have uncovered what was wrong. There was ground for suspicion also because of the inflation of the inventory. The inventory as it was given to the auditors, was totaled at $347,219.08. The defendants discovered errors in the sum of $303,863.20, and adjusted the balance sheet accordingly. Both the extent of the discrepancy and its causes might have been found to cast discredit upon the business and the books. There was ground for suspicion again in the record of assigned accounts. Inquiry of the creditors gave notice to the defendants that the same accounts had been pledged to two, three and four banks at the same time. The pledges did not diminish the value of the assets, but made in such circumstances they might well evoke a doubt as to the solvency of a business where such conduct was permitted. There was an explanation by Romberg which the defendants accepted as sufficient. Caution and diligence might have pressed investigation farther.

When the above evidence was introduced, the defendants replied that

1. their audit was what is known technically as a balance sheet audit, made as is customary by the testing and sampling method which tests and samples the accuracy of records by selecting a few items, the correctness of which, if established, results in the acceptance of such records as being accurate, this method not pretending to be exhaustive as a complete audit, the expense of which is often prohibitive; and that it was "in accordance. . . . with the information and explanations" given to the defendants and that at the time it presented in their "opinion" a true and correct view of the financial condition of Stern & Co. as of December 31, 1923.

2. that they had no reason to suspect the good faith of any of the officers of Stern & Co. and that the discrepancy observed in the assignments of accounts receivable was explained by the officers of Stern & Co. to their satisfaction; that the reports obtained from lending institutions were not complete, and that the defendants took for the purposes of their audit the greater amount shown by the day to day record of Stern & Co. rather than the smaller amount as indicated by the reports of the banks.

3. that there was nothing to indicate that the items in question were fictitious and that they received a certificate from the president and cashier of Stern & Co. to the effect that the inventory was correct and that all liabilities to creditors, banks or bankers, in respect to the inventory were shown on the books of the corporation.

4. that they inquired of the officers of Stern & Co. and were informed that the United Baltic account showed an amount due from the creditor instead of an amount due to the creditor because the creditor had required Stern & Co. to deliver to it sterling credit in order to secure further purchases from the creditor by Stern & Co.; and that a further certificate was received from the president and cashier of Stern & Co. to the effect that all liabilities of Stern & Co., at December 31, 1923, were shown on the books of the corporation at that date.

5. that they had made balance sheet audits of Stern & Co. as of December 31st, of the preceding years of 1920, 1921, and 1922, and that no unusual conditions had been found then to exist; that they were retained by the president of Stern & Co. to examine the books and accounts of Stern & Co. and to give their certificate as to its financial condition as of December 31, 1923, and that they had no cause to suspect his good faith, honesty, or integrity; and that the errors in the books and accounts of Stern & Co. which were found by them, were such as often found in auditing, without causing unfavorable comment or suspicion, and that such errors were corrected before the audit was completed.

The case was tried before Judge Walsh who, at the close of the testimony, directed a verdict for the defendants on the fraud charge, but left it to the jury to decide whether the defendants had been negligent. The jury rendered a verdict against the

accountants and made an award for $187,576.32, which the judge set aside on the ground that negligence is not actionable unless there is a breach of duty owing by the defendant (in this case the auditors) to the plaintiff (Ultra Mares Corporation). He stated:

> There must exist between the party inflicting the injury and the one injured some privity (connection) by contract or otherwise by reason of which the former owes some legal duty to the latter. Contractually, the defendants owed no duty to plaintiff because no such relationship existed between them, nor was there such privity between the plaintiff and defendants as to impose upon the latter a liability to the former for their negligence in performing their contract obligation with Stern and Company.

This decision was modified by a judgment of the Appellate Division, First Department, of the Supreme Court of New York which affirmed Judge Walsh's action in dismissing the complaint as to fraud, but reversed his decision dismissing the complaint as to negligence. The verdict of the jury in favor of the plaintiff was reinstated and judgment thereon in the sum of $203,058.97 was awarded. The case was then carried to the highest court in New York State, the Court of Appeals. Cross-appeals were filed; the defendant appealed that part of the judgment of the Appellate Division relating to negligence; the plaintiff, that part of the judgment relating to fraud. The Court of Appeals reversed the judgment of the Appellate Division on both causes of action, holding that there was no relation between the accountants and the Ultra Mares Corporation which gave rise to a liability by the former to the latter for negligence, but that Judge Walsh was wrong in refusing to leave to the jury the charge of fraud. Excerpts from the decision of Judge Cardozo of the Court of Appeals are given below:

> The two causes of action will be considered in succession, first the one for negligence and second that for fraud.
>
> 1. We think the evidence supports a finding that the audit was negligently made, though in so saying we put aside for the moment the question whether negligence, even if it existed, was a wrong to the plaintiff. . . .
>
> . . . .
>
> The defendants owed to their employer a duty imposed by law to make their certificate without fraud, and a duty growing out of contract to make it with the care and caution proper to their calling. Fraud includes the pretense of knowledge when knowledge there is none. To

creditors and investors to whom the employer exhibited the certificate, the defendants owed a like duty to make it without fraud, since there was notice in the circumstances of its making that the employer did not intend to keep it to himself . . . A different question develops when we ask whether they owed a duty to these to make it without negligence. If liability for negligence exists, a thoughtless slip or blunder, the failure to detect a theft or forgery beneath the cover of deceptive entries, may expose accountants to a liability in an indeterminate amount for an indeterminate time as to an indeterminate class. The hazards of a business conducted on these terms are so extreme as to enkindle doubt whether a flaw may not exist in the implication of a duty that exposes to these consequences. We put aside for the moment any statement in the certificate which involves the representation of a fact as true to the knowledge of the auditors. If such a statement was made, whether believed to be true or not, the defendants are liable for deceit in the event that it was false. The plaintiff does not need the invention of novel doctrine to help it out in such conditions. The case was submitted to the jury and the verdict was returned upon the theory that even in the absence of a misstatement of a fact there is a liability also for erroneous opinion. The expression of an opinion is to be subject to a warranty implied by law. What, then, is the warranty, as yet unformulated, to be? Is it merely that the opinion is honestly conceived and that the preliminary inquiry has been honestly pursued, that a halt has not been made without a genuine belief that the search has been reasonably adequate to bring disclosure of the truth? Or does it go farther and involve the assumption of a liability for any blunder or inattention that could fairly be spoken of as negligence if the controversy were one between accountant and employer for breach of a contract to render services for pay?

. . . .

Even an opinion, especially an opinion by an expert, may be found to be fraudulent if the grounds supporting it are so flimsy as to lead to the conclusion that there was no genuine belief back of it. . . .

. . . .

Our holding does not emancipate accountants from the consequences of fraud. It does not relieve them if their audit has been so negligent as to justify a finding that they had no genuine belief in its adequacy, for this again is fraud. It does no more than say that if less than this is proved, if there has been neither reckless misstatement nor insincere profession of an opinion, but only honest blunder, the ensuing liability for negligence is one that is bounded by the contract, and is to be enforced between the parties by whom the contract has been made. We doubt whether the average business man receiving a certificate without paying for it and receiving it merely as one among a multitude of possible investors, would look for anything more.

The second cause of action is yet to be considered.

The defendants certified, as a fact, true to their own knowledge, that the balance sheet was in accordance with the books of account.

If their statement was false, they are not to be exonerated because they believed it to be true. . . .

Correspondence between the balance sheet and the books imports something more, or so the triers of the facts might say, than correspondence between the balance sheet and the general ledger, unsupported or even contradicted by every other record. The correspondence to be of any moment may not unreasonably be held to signify a correspondence between the statement and the books of original entry, the books taken as a whole. If that is what the certificate means, a jury could find that the correspondence did not exist and that the defendants signed the certificates without knowing it to exist and even without reasonable grounds for belief in its existence. . . .

In this connection we are to bear in mind the principle already stated in the course of this opinion that negligence or blindness, even when not equivalent to fraud, is none the less evidence to sustain an inference of fraud. At least this is so if the negligence is gross. . . .

The defendants attempt to excuse the omission of an inspection of the invoices proved to be fictitious by invoking a practice known as that of testing and sampling. A random choice of accounts is made from the total number on the books, and these, if found to be regular when inspected and investigated, are taken as a fair indication of the quality of the mass. The defendants say that about 200 invoices were examined in accordance with this practice, but they do not assert that any of the seventeen invoices supporting the fictitious sales were among the number so selected. Verification by test and sample was very likely a sufficient audit as to accounts regularly entered upon the books in the usual course of business. It was plainly insufficient, however, as to accounts not entered upon the books where inspection of the invoices was necessary, not as a check upon accounts fair upon their face, but in order to ascertain whether there were any accounts at all. If the only invoices inspected were invoices unrelated to the interpolated entry, the result was to certify a correspondence between the books and the balance sheet without any effort by the auditors, as to $706,000 of accounts, to ascertain whether the certified agreement was in accordance with the truth. How far books of account fair upon their face are to be probed by accountants in an effort to ascertain whether the transactions back of them are in accordance with the entries, involves to some extent the exercise of judgment and discretion. Not so, however, the inquiry whether the entries certified as there, are there in very truth, there in the form and in the places where men of business training would expect them to be. The defendants were put on their guard by the circumstances touching the December accounts receivable to scrutinize with special care. A jury might find that with suspicions thus awakened, they closed their eyes to the obvious, and blindly gave assent.

We conclude, to sum up the situation, that in certifying to the correspondence between balance sheet and accounts the defendants made a statement as true to their own knowledge, when they had, as a

jury might find, no knowledge on the subject. If that is so, they may also be found to have acted without information leading to a sincere or genuine belief when they certified to an opinion that the balance sheet faithfully reflected the condition of the business.

Whatever wrong was committed by the defendants was not their personal act or omission, but that of their subordinates. This does not relieve them, however, of liability to answer in damages for the consequences of the wrong, if wrong there shall be found to be. . . .

Upon the defendants' appeal as to the first cause of action, the judgment of the Appellate Division should be reversed and that of the trial term affirmed with costs in the Appellate Division and in this court.

Upon the plaintiff's appeal as to the second cause of action, the judgment of the Appellate Division and that of the trial term should be reversed, and a new trial granted, with costs to abide the event.

It was announced in June, 1931, that the case had been settled out of court so that a new trial did not take place. The terms of settlement were not publicly stated.

To what extent does the decision rendered by Judge Cardozo limit the liability of public accountants in certifying to a balance sheet?

8. SECURITIES ACT OF 1933 WITH AMENDMENT OF 1934

ACCOUNTANTS' LIABILITIES: WHAT WAS THE EFFECT OF THE SECURITIES ACT OF 1933 UPON THE LIABILITIES OF PUBLIC ACCOUNTANTS?

On May 27, 1933, the Securities Act of 1933 became law. Its primary objective was the protection of investors in the issuance of securities. Among its provisions were those defining the responsibilities of public accountants who, along with other experts and professional men, were made subject to new liabilities in connection with the issuance of securities. Liabilities of public accountants arose through the necessity of their certifying statements prepared for and included in the registration statements which had to be filed with the Securities and Exchange Commission.[1]

[1] The act of 1933 provided for registration with the Federal Trade Commission, but the revision of 1934 (Securities Exchange Act) created the Securities and Exchange Commission which was to take over all functions bestowed upon the Federal Trade Commission by the Securities Act of 1933.

Schedule A of the act, which outlined the information required in the registration statements, specified in part that the statements should contain:

. . . .

(25) a balance sheet as of a date not more than ninety days prior to the date of the filing of the registration statement showing all of the assets of the issuer, the nature and cost thereof, whenever determinable, in such detail and in such form as the Commission shall prescribe (with intangible items segregated), including any loan in excess of $20,000 to any officer, director, stockholder or person directly or indirectly controlling or controlled by the issuer, or person under direct or indirect common control with the issuer. All the liabilities of the issuer in such detail and such form as the Commission shall prescribe, including surplus of the issuer showing how and from what sources such surplus was created, all as of a date not more than ninety days prior to the filing of the registration statement. If such statement be not certified by an independent public or certified accountant, in addition to the balance sheet required to be submitted under this schedule, a similar detailed balance sheet of the assets and liabilities of the issuer, certified by an independent public or certified accountant, of a date not more than one year prior to the filing of the registration statement, shall be submitted;

(26) a profit and loss statement of the issuer showing earnings and income, the nature and source thereof, and the expenses and fixed charges in such detail and such form as the Commission shall prescribe for the latest fiscal year for which such statement is available and for the two preceding fiscal years, year by year, or, if such issuer has been in actual business for less than three years, then for such time as the issuer has been in actual business, year by year. If the date of the filing of the registration statement is more than six months after the close of the last fiscal year, a statement from such closing date to the latest practicable date. Such statement shall show what the practice of the issuer has been during the three years or lesser period as to the character of the charges, dividends or other distributions made against its various surplus accounts, and as to depreciation, depletion, and maintenance charges, in such detail and form as the Commission shall prescribe, and if stock dividends or avails from the sale of rights have been credited to income, they shall be shown separately with a statement of the basis upon which the credit is computed. Such statement shall also differentiate between any recurring and nonrecurring income and between any investment and operating income. Such statement shall be certified by an independent public or certified accountant;

. . . .

Section 11 (*a*) defined the liabilities of those signing the registration statement. It provided the following:

11 (*a*) In case any part of the registration statement, when such part became effective, contained an untrue statement of a material fact or omitted to state a material fact required to be stated therein or necessary to make the statements therein not misleading, any person acquiring such security (unless it is proved that at the time of such acquisition he knew of such untruth or omission) may, either at law or in equity, in any court of competent jurisdiction, sue—

(1) every person who signed the registration statement;

(2) every person who was a director of (or person performing similar functions) or partner in, the issuer at the time of the filing of the part of the registration statement with respect to which his liability is asserted;

(3) every person who, with his consent, is named in the registration statement as being or about to become a director, person performing similar functions, or partner;

(4) every accountant, engineer, or appraiser, or any person whose profession gives authority to a statement made by him, who has with his consent been named as having prepared or certified any part of the registration statement, or as having prepared or certified any report or valuation which is used in connection with the registration statement, with respect to the statement in such registration statement, report, or valuation, which purports to have been prepared or certified by him;

(5) every underwriter with respect to such security.

Section 11 (*b*) outlined the conditions under which signatories to the registration statement could avert liability.

11 (*b*) Notwithstanding the provisions of subsection (*a*) no person, other than the issuer, shall be liable as provided therein who shall sustain the burden of proof—

(1) that before the effective date of the part of the registration statement with respect to which his liability is asserted (*A*) he had resigned from or had taken such steps as are permitted by law to resign from, or ceased or refused to act in, every office, capacity, or relationship in which he was described in the registration statement as acting or agreeing to act, and (*B*) he had advised the Commission and the issuer in writing that he had taken such action and that he would not be responsible for such part of the registration statement; or

(2) that if such part of the registration statement became effective without his knowledge, upon becoming aware of such fact he forthwith acted and advised the Commission, in accordance with paragraph (1), and, in addition, gave reasonable public notice that such part of the registration statement had become effective without his knowledge; or

(3) that (*A*) as regards any part of the registration statement not purporting to be made on the authority of an expert, and not pur-

porting to be a copy of or extract from a report or valuation of an expert, and not purporting to be made on the authority of a public official document or statement, he had, after reasonable investigation, reasonable ground to believe and did believe, at the time such part of the registration statement became effective, that the statements therein were true and that there was no omission to state a material fact required to be stated therein or necessary to make the statements therein not misleading; and (*B*) as regards any part of the registration statement purporting to be made upon his authority as an expert or purporting to be a copy of or extract from a report or valuation of himself as an expert, (i) he had, after reasonable investigation, reasonable ground to believe and did believe, at the time such part of the registration statement became effective, that the statements therein were true and that there was no omission to state a material fact required to be stated therein or necessary to make the statements therein not misleading, or (ii) such part of the registration statement did not fairly represent his statement as an expert or was not a fair copy of or extract from his report or valuation as an expert; and (*C*) as regards any part of the registration statement purporting to be made on the authority of an expert (other than himself) or purporting to be a copy of or extract from a report or valuation of an expert (other than himself), he had reasonable ground to believe and did believe, at the time such part of the registration statement became effective, that the statements therein were true and that there was no omission to state a material fact required to be stated therein or necessary to make the statements therein not misleading, and that such part of the registration statement fairly represented the statement of the expert or was a fair copy of or extract from the report or valuation of the expert; and (*D*) as regards any part of the registration statement purporting to be a statement made by an official person or purporting to be a copy of or extract from a public official document, he had reasonable ground to believe and did believe, at the time such part of the registration statement became effective, that the statements therein were true, and that there was no omission to state a material fact required to be stated therein or necessary to make the statements therein not misleading, and that such part of the registration statement fairly represented the statement made by the official person or was a fair copy of or extract from the public official document.

11 (*c*) In determining, for the purpose of paragraph (3) of subsection (*b*) of this section, what constitutes reasonable investigation and reasonable ground for belief, the standard of reasonableness shall be that required of a person occupying a fiduciary relationship.

. . . .

The extent of liability was defined in Section 11 (*e*) which provided:

11 (*e*) The suit authorized under subsection (*a*) may be either (1) to recover the consideration paid for such security with interest thereon, less the amount of any income received thereon, upon the tender of such security, or (2) for damages if the person suing no longer owns the security.[1]

Serious objections were made to the rigidity of the provisions of the Securities Act of 1933 and as a result some modifications

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[1] The Securities Act of 1933 was patterned after the English Companies Act of 1929 and although seeking to achieve the same ends its provisions with respect to liabilities for misstatement of fact were far more rigid than those under the Companies Act. Section 37 of the Companies Act, dealing with liabilities under the act, read in part as follows:

(1) Where a prospectus invites persons to subscribe for shares in or debentures of a company—

(*a*) every person who is a director of the company at the time of the issue of the prospectus; and

(*b*) every person who has authorised himself to be named and is named in the prospectus as a director or as having agreed to become a director either immediately or after an interval of time; and

(*c*) every person being a promoter of the company; and

(*d*) every person who has authorised the issue of the prospectus, shall be liable to pay compensation to all persons who subscribe for any shares or debentures on the faith of the prospectus for the loss or damage they may have sustained by reason of any untrue statement therein, or in any report or memorandum appearing on the face thereof, or by reference incorporated therein or issued therewith, unless it is proved—

(i) that having consented to become a director of the company he withdrew his consent before the issue of the prospectus, and that it was issued without his authority or consent; or

(ii) that the prospectus was issued without his knowledge or consent, and that on becoming aware of its issue he forthwith gave reasonable public notice that it was issued without his knowledge or consent; or

(iii) that after the issue of the prospectus and before allotment thereunder, he, on becoming aware of any untrue statement therein, withdrew his consent thereto, and gave reasonable public notice of the withdrawal, and of the reason therefor; or

(iv) that—

(*a*) as regards every untrue statement not purporting to be made on the authority of an expert or of a public official document or statement, he had reasonable ground to believe, and did up to the time of the allotment of the shares or debentures, as the case may be, believe, that the statement was true; and

(*b*) as regards every untrue statement purporting to be a statement by an expert or contained in what purports to be a copy of or extract from a report or valuation of an expert, it fairly represented the statement, or was a correct and fair copy of or extract from the report or valuation; and

(*c*) As regards every untrue statement purporting to be a statement made by an official person or contained in what purports to be a copy of or extract from a public official document, it was a correct and fair representation of the statement or copy of or extract from the document:

Provided that a person shall be liable to pay compensation as aforesaid if it is proved that he had no reasonable ground to believe that the person making any such statement, report or valuation as is mentioned in paragraph (iv) (*b*) of this subsection was competent to make it.

of the liabilities of signatories to registration statements were embodied in the Securities Exchange Act which became law in June, 1934.

Among the more important modifications was that limiting the possibilities of recovery under the act when the loss suffered could not be attributed to reliance upon a misstatement or omission of fact. Section 11 (*a*) of the revised act provided:

11 (*a*) If such person acquired the security after the issuer has made generally available to its security holders an earning statement covering a period of at least 12 months beginning after the effective date of the registration statement, then the right of recovery under this subsection shall be conditioned on proof that such person acquired the security relying upon such untrue statement in the registration statement or relying upon the registration statement and not knowing of such omission, but such reliance may be established without proof of the reading of the registration statement by such person.

The extent of the liability of signatories was also modified by revision of Section 11 (*e*):

11 (*e*) The suit authorized under subsection (*a*) may be to recover such damages as shall represent the difference between the amount paid for the security (not exceeding the price at which the security was offered to the public) and (1) the value thereof as of the time such suit was brought, or (2) the price at which such security shall have been disposed of in the market before suit, or (3) the price at which such security shall have been disposed of after suit but before judgment if such damages shall be less than the damages representing the difference between the amount paid for the security (not exceeding the price at which the security was offered to the public) and the value thereof as of the time such suit was brought: Provided, That if the defendant proves that any portion or all of such damages represents other than the depreciation in value of such security resulting from such part of the registration statement, with respect to which his liability is asserted, not being true or omitting to state a material fact required to be stated therein or necessary to make the statements therein not misleading, such portion of or all such damages shall not be recoverable. In no event shall any underwriter (unless such underwriter shall have knowingly received from the issuer for acting as an underwriter some benefit, directly or indirectly, in which all other underwriters similarly situated did not share in proportion to their respective interests in the underwriting) be liable in any suit or as a consequence of suits authorized under subsection (*a*) for damages in excess of the total price at which the securities underwritten by him and distributed to the public were offered to the public. In any suit under this or any other section of

this title the court may, in its discretion, require an undertaking for the payment of the costs of such suit, including reasonable attorney's fees, and if judgment shall be rendered against a party litigant, upon the motion of the other party litigant, such costs may be assessed in favor of such party litigant (whether or not such undertaking has been required) if the court believes the suit or the defense to have been without merit, in an amount sufficient to reimburse him for the reasonable expenses incurred by him, in connection with such suit, such costs to be taxed in the manner usually provided for taxing of costs in the court in which the suit was heard.

Further modifications were made in the limitations of actions (Section 13) under the act. As revised, it was necessary for an investor claiming loss to bring suit within one year (originally two) of the time of the discovery of the untrue statement or the time at which it should have been discovered by the exercise of reasonable diligence. It further provided: "In no case shall any action be brought to enforce a liability created under Section 11 . . . more than three (originally ten) years after the security was bona fide offered to the public."

The standard of reasonableness, originally defined in Section 11 (*c*) was changed to "that required of a prudent man in the management of his own property."

What are the liabilities of accountants with respect to the issuance of securities? Are they reasonable?

Compare these liabilities with those existing before the passage of the act.

What was the significance of the modifications in the Securities Exchange Act of 1934?

9. RULES OF PROFESSIONAL CONDUCT[1]

RESPONSIBILITIES: WHAT ARE THE PROFESSIONAL RESPONSIBILITIES OF AUDITORS AND PUBLIC ACCOUNTANTS?

The Rules of Professional Conduct of the American Institute of Accountants are as follows:

[1] *The Journal of Accountancy*, February, 1941, pp. 160–161.

Rules of Professional Conduct

(Declared effective January 6, 1941)
(As amended September 18, 1941)

RULE NO. 1

A firm or partnership, all the individual members of which are members of the Institute (or in part members and in part associates, provided all the members of the firm are either members or associates), may describe itself as "Members of the American Institute of Accountants," but a firm or partnership, not all the individual members of which are members of the Institute (or in part members and in part associates), or an individual practising under a style denoting a partnership when in fact there be no partner or partners, or a corporation, or an individual or individuals practising under a style denoting a corporate organization shall not use the designation "Members (or Associates) of the American Institute of Accountants."

RULE NO. 2

A member or an associate shall not allow any person to practise in his name who is not in partnership with him or in his employ.

RULE NO. 3

Commissions, brokerage or other participation in the fees or profits of professional work shall not be allowed directly or indirectly to the laity by a member or an associate.

Commissions, brokerage or other participation in the fees, charges or profits of work recommended or turned over to the laity as incident to services for clients shall not be accepted directly or indirectly by a member or an associate.

RULE NO. 4

A member or an associate shall not engage in any business or occupation conjointly with that of a public accountant, which is incompatible or inconsistent therewith.

RULE NO. 5

In expressing an opinion on representations in financial statements which he has examined, a member or an associate shall be held guilty of an act discreditable to the profession if:

(*a*) He fails to disclose a material fact known to him which is not disclosed in the financial statements but disclosure of which is necessary to make the financial statements not misleading; or

(*b*) He fails to report any material misstatement known to him to appear in the financial statements; or

(*c*) He is grossly negligent in the conduct of his examination or in making his report thereon; or

(*d*) He fails to acquire sufficient information to warrant expression of an opinion, or his exceptions are sufficiently material to negative the expression of an opinion; or

(*e*) He fails to direct attention to any material departure from generally accepted accounting principles or to disclose any material omission of generally accepted auditing procedure applicable in the circumstances.

RULE NO. 6

A member or an associate shall not sign a report purporting to express his opinion as the result of examination of financial statements unless they have been examined by him, a member or an employee of his firm, a member or an associate of the Institute, a member of a similar association in a foreign country, or a certified public accountant of a state or territory of the United States or the District of Columbia.

RULE NO. 7

A member or an associate shall not directly or indirectly solicit the clients or encroach upon the practice of another public accountant, but it is the right of any member or associate to give proper service and advice to those asking such service or advice.

RULE NO. 8

Direct or indirect offer of employment shall not be made by a member or an associate to an employee of another public accountant without first informing such accountant. This rule shall not be construed as to inhibit negotiations with anyone who of his own initiative or in response to public advertisement shall apply to a member or an associate for employment.

RULE NO. 9

Professional service shall not be rendered nor offered for a fee which shall be contingent upon the findings or results of such service. This rule does not apply to cases involving federal, state or other taxes, in which the findings are those of the tax authorities and not those of the accountant. Fees to be fixed by courts or other public authorities, which are therefore of an indeterminate amount at the time when an engagement is undertaken, are not regarded as contingent fees within the meaning of this rule.

RULE NO. 10

Members or associates shall not advertise their professional attainments or services, but the publication of what is technically known as a card is not prohibited by this rule. A card is defined as an advertisement of the name, title (member of American Institute of Accountants, C.P.A., or other professional affiliation or designation), class of service, and address of the advertiser, or announcement of change of address or personnel of firm, not exceeding two columns in width and three inches in depth if appearing in a newspaper, or not exceeding one-quarter of a page if appearing in a magazine, directory, or similar publication.

RULE NO. 11

A member or an associate shall not be an officer, director, stockholder, representative or agent of any corporation engaged in the prac-

tice of public accounting in any state or territory of the United States or the District of Columbia.

RULE NO. 12

A member or an associate shall not permit his name to be used in conjunction with an estimate of earnings contingent upon future transactions in a manner which may lead to the belief that the member or associate vouches for the accuracy of the forecast.

RULE NO. 13

A member or an associate shall not express his opinion on financial statements of any enterprise financed in whole or in part by public distribution of securities, if he is himself the actual or beneficial owner of a substantial financial interest in the enterprise or if he is committed to acquire such an interest; nor shall a member or an associate express his opinion on financial statements which are used as a basis of credit, if he is himself the actual or beneficial owner of a substantial financial interest in the enterprise or if he is committed to acquire such interest, unless he discloses his financial interest in his report.

RULE NO. 14

A member or an associate shall not make a competitive bid for professional engagements in any state, territory or the District of Columbia, if such a bid would constitute a violation of any rule of the recognized society of certified public accountants or the official board of accountancy in that state, territory, or district.

RULE NO. 15

A member or an associate of the American Institute of Accountants engaged simultaneously in the practice of public accounting and in another occupation must in both capacities observe the by-laws and rules of professional conduct of the Institute.

RULE NO. 16

A member or an associate shall not violate the confidential relationship between himself and his client.

As an auditor how would you be affected by each of the foregoing provisions? Can you cite examples of their violation?

10. SOUTHERN NATURAL GAS COMPANY[1]

RESPONSIBILITIES OF AUDITORS: WHAT ARE THE DUTIES AND RIGHTS OF AUDITORS WHEN ELECTED BY STOCKHOLDERS?

The following statement appeared in the certificate of incorporation of the Southern Natural Gas Company:

At each annual meeting of the stockholders, or at an adjournment thereof, there shall be elected by plurality vote of the outstanding shares of the class A stock an auditor of the corporation, who shall hold office until the next annual meeting of stockholders. The board of directors may appoint an auditor to hold office until the first annual meeting of the stockholders. . . . The auditor shall be an individual who is a member in good standing of the American Institute of Accountants or (if said Institute shall cease to exist) of its successor or an organization of comparable standing, or shall be a co-partnership a majority of whose members are members in good standing of said Institute or its successor or comparable organization as aforesaid; and shall in any event have rendered audit reports for at least five corporations or associations each having at the time of such reports assets carried on their respective balance-sheets at more than $20,000,000. The auditor shall not be a director of the corporation, nor (except an auditor then in office) an officer or salaried employee thereof. Not later than thirty days prior to the day fixed for the annual meeting of stockholders in any year, the auditor shall submit a written report by the auditor as to the balance-sheet of the corporation as at the close of business on the December 31 next preceding the date of such report, as to the surplus account of the corporation and as to the earnings or income of the corporation since its organization or since the last preceding report by the auditor as the case may be. The corporation shall cause copies of such report to be mailed not later than twenty days prior to the day fixed for such annual meeting to each stockholder of record of the corporation. The board of directors of the corporation shall cause to be included in the notice given to stockholders of each annual meeting a statement of the name of the individual or copartnership which the board of directors recommends for election as auditor at such meeting, and also a statement of the name of the auditor then in office; but no such recommendation by the board of directors shall be binding upon the stockholders. The board of directors shall cause a copy of such notice to be mailed to the existing auditor at the same time at which it is mailed or otherwise given to stockholders. No person, other than the auditor then in office, shall be eligible for election as auditor at any annual meeting of stockholders unless notice of intention to nominate that person as auditor has been given by a stockholder to the corporation not less than ten days before such annual

[1] Quoted in *The Journal of Accountancy*, February, 1936, pp. 81–82.

meeting; the corporation shall promptly mail a copy of such notice to the auditor then in office. The auditor shall have the right to attend all meetings of stockholders at which the auditor or any accounts of the corporation examined or reported on by the auditor are considered, and to make any statement or explanation regarding the accounts which the auditor may desire; but the auditor shall not be entitled to any vote. The auditor shall have the right of access to all books, accounts, vouchers and records of the corporation and may require from its officers such information and explanation as may be necessary for the performance of the duties of the auditor. The officers and directors of the corporation may rely upon the accuracy of all reports by the auditor to the corporation or its stockholders and will be protected in any action or non-action by them in good faith in reliance thereon. Semi-annual, quarterly or interim reports shall be made by the auditor from time to time as may be directed by the board of directors of the corporation. The board of directors may fill any vacancy occurring in the office of auditor, by death, resignation or otherwise, at any time except between the call and final adjournment of an annual meeting of stockholders or of a special meeting of stockholders called for the purpose of removing the auditor or electing a new auditor. The auditor may be removed, and a new auditor elected to fill the vacancy caused by such removal or otherwise, at any special meeting of the stockholders the notice of which shall include such removal and election as purposes of the meeting, by the vote of a majority of the outstanding shares of the class A stock of the corporation; a copy of the notice of any such meeting shall be mailed by the corporation to the auditor then in office at the same time at which such notice is mailed or otherwise given to stockholders. The auditor shall receive as compensation for all services performed by the auditor such amount as from time to time shall be fixed by the board of directors within such limits, if any, as may from time to time be determined by the stockholders.

What duties and rights of auditors arise out of this statement?

Would you recommend amending certificates of incorporation of established companies to include statements similar to this?

CHAPTER III

BEGINNING THE AUDIT

11. ATCHISON SHOE COMPANY—No. 1

AUDIT PREPARATION: WHAT INFORMATION IS DESIRABLE BEFORE BEGINNING THE AUDIT?

The annual balance sheet of the Atchison Shoe Company had never been audited by independent accountants. Upon recommendation of his bank, Mr. Ewald, president of the company, decided that an audit should be made and on September 3, 1931, talked with Mr. Fosdick of the public accounting firm of Eaton, Fosdick & Company. Mr. Fosdick was a personal acquaintance of Mr. Ewald and his firm had been recommended to Mr. Ewald by the treasurer of Leather Importers, Inc., from whom the Atchison Shoe Company made large purchases.

Although Mr. Ewald knew that the cost of an annual audit made by Eaton, Fosdick & Company of Leather Importers, Inc., was not excessive, he desired to know the approximate cost of an audit of the Atchison Shoe Company. Mr. Fosdick pointed out that the price could not be determined until he knew more about the company and its system of accounts, and even then it could only be approximated. He believed that an understanding of the scope of the audit was essential, in order to prevent later disagreement.

In order to find out about the company's system of accounts and make arrangements for the audit, Mr. Fosdick interviewed the president and treasurer of the Atchison Shoe Company on September 10. After returning to his office, he dictated the following memorandum:

September 10, 1931	No. 46J
Atchison Shoe Company	Audit for period November 1,
14 Parker St., St. Louis, Mo.	1930 to October 31, 1931

Memorandum of Work to be Done

I talked with Mr. Ewald, president, and Mr. Donovan, treasurer of the Atchison Shoe Company at their offices regarding the

audit tentatively arranged on September 3. The company manufactures boys' and girls' shoes and sells direct to the retail trade throughout the country. Sales covering a wide range of styles, sizes and widths have averaged $2,400,000 annually. The company operates a modern system of accounting and obtains monthly financial statements. Inventories are taken on the old season and new season basis.[1] Inventories of raw materials, work in process, and finished shoes are controlled through the application of a system of standard or predetermined costs and the cost accounting records are tied in with the general records of the company, making it possible to obtain the monthly financial statements referred to above. The production of shoes is carefully scheduled and work in the factory is performed on the basis of day sheets which facilitate the movement of work in process through the departments. Every shoe is figured in detail prior to being put into production and the costs, as figured, form the basis for controlling the application of material and labor to the shoes being produced. All losses or gains in the application of material and direct labor and in the absorption of overhead are determined monthly.

The scope of the audit was agreed upon. A complete verification of the assets and liabilities at the close of the fiscal year and an extensive verification of income and expenses are desired for preparation of:

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[1] This was the practice pursued in most shoe manufacturing concerns in 1931. Under this method the manufacturing departments were shut down one at a time for one or two days in the order in which shoes moved through the factory. For example, cutting was stopped on October 17 after all the materials in the room had been cut, matched, and sent to the stitching room. The cutting room inventory was then taken during which time the stitching room was still operating. The cutting room was usually idle for two or three days after the inventory was taken until the stitching room was cleaned out. Then the cutting room started up and the inventory of the stitching room was taken. This practice followed down through the plant and the finished shoes were delivered to the stock room before the inventory of the packing room was taken. While some manufacturing time was lost by this method of taking inventory, it was not much and the method was usually satisfactory to the manufacturer. Raw materials were inventoried in sections as was done in the case of the operating departments, all upper leather being inventoried when the cutting room was inventoried, etc.

It should be borne in mind that there was an in-process inventory at the audit date comprised of the new season's run which was started by the several departments after the shutdown for inventory taking. Materials in the manufacturing departments at the audit date were classed as raw materials, and labor expended on the new run was carried in a separate asset account called new season's labor. Overhead on the new run was not considered as it was usually small. This method had to be followed with extreme care as during the time of taking the inventory new-run merchandise purchases were coming in and these goods could not be taken into the old-run inventory or the bills entered on the old-run books. Labor had to be carefully segregated between old and new run and proper distribution made on the books. All incoming merchandise for the new run had to be laid aside, preferably in one place, and the bills for this merchandise dealt with similarly.

(1) Detailed Audit Report to Stockholders
(2) Certified Balance Sheet and Related Income Statement for Credit Purposes[1]
(3) Federal Income Tax Return

It was explained that the extent of test checking necessary to satisfy ourselves as to the validity of the accounts would of course depend upon the adequacy of the internal check. In this connection it was arranged for Mr. Lane, a senior accountant in our office, to meet Mr. Donovan of the Atchison Shoe Company on September 12 for the purpose of studying the bookkeeping system and outlining a tentative audit program.

Mr. Donovan felt that an audit of the above dimensions could be performed for approximately $2,000, inasmuch as this was the amount paid by friends for similar audits, although not in the same industry. It was pointed out that the cost of an audit, indeterminable in advance, was dependent upon the adequacy of internal check, also that services were customarily rendered on a per diem basis. The following per diem rates were agreed upon with assurance that the probable cost of the audit will not exceed $2,000. Seniors, $30; Juniors, $15; and Principals, a reasonable fee.

Subsidiary accounts will be in balance with the control accounts and a trial balance will be prepared for us when we begin the audit. We are permitted to circularize customers in verifying accounts receivable, the cost of which is to be borne by the company. Vouchers will be sorted and filed in order to facilitate checking with the voucher register. Cancelled checks will be ready for our inspection. Monthly statements from vendors for the last two months will be filed and prepared for our verification. We shall also be presented with a list of receivables and schedules of deferred charges. Statements of customers for October shall be prepared and, after we have checked them against the accounts receivable, they will be mailed to customers. Although the audit is to begin November 15, or as soon thereafter as possible, some preliminary work can be done prior to that date in the verification of inventories. To facilitate the taking of inventory under the old season, new season basis, the manufacturing departments will be closed on the following days:

Upper Leather Stock Room	October 19
Sole Leather Stock Room	October 23
Cutting Room	October 19
Stitching Room	October 23

[1] Mr. Ewald realized that inasmuch as this was the first audit, a more detailed examination of profit and loss would be advisable than under the usual "balance sheet audit."

Stock Fitting Room	October 23
Assembly Room	October 23
Lasting Room	October 26
Making Room	October 29
Finishing Room	October 30
Treeing, Dressing and Packing Room	October 31 (at the close of business)

The principal officers of the company are:

A. C. Ewald, President
A. P. Donovan, Treasurer
P. L. Huston, Comptroller

The Internal Revenue Department has examined the company's books up through 1929 and no adjustments of back taxes are pending.

The St. Louis Trust Company is transfer agent for the company. Ten copies of our report are to be submitted to the president, Mr. Ewald, not later than December 31, 1931.

J. R. Fosdick
9/10/31

What purpose is served by this memorandum?

Would you have desired additional information before beginning the audit on November 1?

12. ATCHISON SHOE COMPANY—No. 2

AN AUDIT PROGRAM: IS A PRELIMINARY SCHEDULING OF WORK DESIRABLE?

In order to carry out arrangements previously made by another member of his firm, Mr. Lane, a senior accountant of Eaton, Fosdick & Company, made an investigation of the accounting system of the Atchison Shoe Company with a view to determining the adequacy of the system of internal check. He ascertained the books of original account, prepared a list of persons who had some connection with keeping the books and their respective duties, and familiarized himself with the accounting procedure of the company. Upon the basis of this investigation he concluded that the company maintained a good system of accounts well kept and that a balance sheet audit was feasible.

Mr. Lane found that the company maintained the following general accounting and cost records:

GENERAL RECORDS

Private Ledger
Private Journal
General Ledger
General Journal
Record of Audited Invoices
Summary of Sales
Record of Cash Received
Record of Cheques Drawn
Record of Goods Received
Accounts Receivable Ledgers
Payroll Book
Perpetual Inventory of Finished Shoes
Manufacturing and Sales Budget Control Record
Minute Book
Stockholders Records
Stock Certificate Record

COST RECORDS

Cost Journal
Record of Upper Leather Cutting
Record of Sole Leather Cutting
Analysis and Summary of Pairs Produced by Stock Numbers and Sub-classification of Product
Analysis and Summary of Shoes Sold and Shoes Returned by Stock Numbers and Sub-classification of Product
Analysis of Work in Process
Cost Figuring Sheet
Day Sheet
Factory Manufacturing and Payroll Coupon Tags

The general and private ledger accounts were as follows:

LIST OF ACCOUNTS

ACCT. No.	ASSETS
	Cash Accounts
1	Office Fund
2	Mississippi National Bank
3	Mid-West National Bank
	Notes Receivable
11	Customers' Notes
12	Sundry Notes
15	Notes Receivable Discounted
	Accounts Receivable
21	Sales Ledger No. 1
22	" No. 2
23	" No. 3
24	" No. 4
25	" No. 5
26	" No. 6
27	Sundry Accounts Receivable
28	Reserve for Losses from Bad Debts
29	Reserve for Discount
	Materials and Supplies
31	Upper Material *A.* Outsides
	B. Linings

C. Trimmings
D.
E.
F. Transfers to Shoemaking
32 Bottom Material *A.* Whole Stock (Leather)
B. Transfers of Whole Stock to Cutting
C. Cut Stock Purchased
D. Cut Stock—Cut
E. Transfers of Cut Stock to Shoemaking
33 Findings *A.* Inventory and Purchases
B. Transfers to Shoemaking
34 Supplies
35 Cartons and Cases *A.* Inventory and Purchases
B. Transfers to Shoemaking
48 Reserve for Adjustment of Inventory to the Lower of Cost or Market
49 Reserve for Discount

Work in Process
51 Work in Process
52 New Run Purchases
53 New Run Labor
54 New Run Expense

Finished Goods
61 Finished Shoes—Regular
62 Samples
63 Mismates and Damages
69 Reserve for Adjustment to Lower of Cost or Market

Plant Accounts
71 Land
72 Buildings
72*D* Reserve for Depreciation—Buildings
73 Machinery and Equipment
73*D* Reserve for Depreciation—Machinery and Equipment
74 Automobile Equipment
74*D* Reserve for Depreciation—Automobile Equipment
75 Lasts, Dies and Patterns

Miscellaneous Assets
81 Transportation Claims
82 Suspense
83 Advances to Salesmen

Deferred Charges
91 Unexpired Insurance
92 Prepaid Interest
93 Prepaid Taxes

LIABILITIES

Notes Payable
101 Bank Discounts
102 Brokers
103 Stockholders and Officers
104 Other

Accounts Payable
111 Purchase Ledger
112 Reserve for Discount

Accrued Liabilities
121 Accrued Payroll
122 Accrued Salaries
123 Accrued Salesmen's Salaries and Commissions
125 Accrued Royalties and Rentals
126 Accrued Taxes

Personal Accounts
131

Dividend Accounts
141 Dividend Payable
Reserve Accounts
151 Reserve for Federal Taxes
Capital Accounts
161 Capital Stock—Common
162 Capital Stock—Preferred
163 Surplus
164 Profit and Loss

REVENUES AND EXPENSES

Sales and Returns
201 Sales of Shoes—Regular
202 Sales of Shoes—Samples
203 Sales of Shoes—Mismates and Damages
205 Sales Returns and Allowances—Shoes—Regular
206 Sales Returns and Allowances—Shoes—Samples
207 Sales Returns and Allowances—Shoes—Mismates and Damages
Deductions from Sales
211 Discounts Allowed
Cost of Sales
221 Cost of Sales—Shoes—Regular
222 Cost of Sales—Shoes—Samples
223 Cost of Sales—Shoes—Mismates and Damages
Selling Expenses
231 Selling Salaries and Commissions
232 Selling Traveling Expenses
233 Advertising
234 Samples Expense
235 Stationery and Printing
236 Telephone and Telegraph
237 Postage
239 Miscellaneous Selling Expenses
Sundry Gains
241 Discounts Received
242 Sales of Rags, Remnants, etc.
244 Profit or Loss on Sale of Capital Assets
245 Interest Received
249 Miscellaneous Sundry Gains
Sundry Losses
251 Interest Paid
252 Estimated Loss from Bad Debts
253 Brokers' Commission
254 Contributions
255 Loss or Gain in Shoemaking
257 Loss or Gain Adjusting Inventories—Finished Shoes
259 Miscellaneous Sundry Losses

SHOEMAKING

Upper Material
501 Upper Material Transfers
502 Loss or Gain in Cutting Uppers
503 Loss on Upper Material for Cripples
504 Loss or Gain Adjusting Inventories—Upper Material
505 Transfers to Work in Process
506 Transfers to Loss or Gain in Shoemaking
Bottom Material
511 Bottom Material Transfers
512 Loss or Gain in Cutting Bottoms
513 Loss or Gain on Purchases of Cut Stock (Maintain Analysis)

514 Loss or Gain Adjusting Inventories—Bottom Material
515 Transfers to Work in Process
516 Transfers to Loss or Gain in Shoemaking
517 Loss on Bottom Material for Cripples

Direct Labor

521 Cutting Uppers
522 Sole Leather
523 Stitching
524 Lasting
525 Making
526 Finishing
527 Repairing and Packing
529 Transfers to Work in Process *A.* Cutting
B. Sole Leather
C. Stitching
D. Lasting
E. Making
F. Finishing
G. Repairing and Packing
539 Transfers to Loss or Gain in Shoemaking *A.* Cutting
B. Sole Leather
C. Stitching
D. Lasting
E. Making
F. Finishing
G. Repairing and Packing

Miscellaneous Direct Charges

541 Findings
542 Cartons and Cases
543 Royalty and Rentals
544 Lasts
548 Transfers to Work in Process *A.* Findings
B. Cartons and Cases
C. Royalty and Rentals
D. Lasts
549 Transfers to Loss or Gain in Shoemaking *A.* Findings
B. Cartons and Cases
C. Royalty and Rentals
D. Lasts

Factory and General Overhead

551 Indirect Labor *A.* Salaries—Foremen
B. Salaries—Factory Clerical
C. Cutting
D. Sole Leather
E. Stitching
F. Lasting
G. Making
H. Finishing
J. Repairing and Packing
K. Receiving and Shipping
L. General Labor
552 Heat, Light and Power *A.* Wages of Engineer and Firemen
B. Supplies and Expense

Factory and General Overhead

555 Insurance
556 Taxes
557 Repairs to Plant
558 Repairs to Machinery and Equipment
559 Machine Parts
560 Depreciation of Building

561 Depreciation of Machinery
562 Automobile Expense-Trucks *A.* Wages of Chauffeur and Lumpers
B. Supplies and Expense
C. Depreciation of Auto Trucks
563 Freight and Express Inward
564 Freight and Express and Parcel Postage Outward
567 Forms and Tree Feet
568 Dies and Patterns
569 General Supplies (Thread, Glue, etc.)
574 Official Salaries
575 Office Salaries
576 Factory and General Traveling
577 Legal Expense
579 Telephone and Telegraph
580 Stationery and Printing
581 Postage
582 Association Dues
583 Collection and Investigation Expense
584 Loss on Work Shoes Returned
585 Loss on Factory Damages
586 Trial Runs
587 Sundry Factory Expenses
588 Sundry Office Expenses
598 Transfers to Work in Process
599 Transfers to Loss or Gain in Shoemaking

The operations of the company were divided into two main divisions as follows:

1. Manufacturing or purchasing parts (uppers, soles, heels, counters, etc.).
2. Shoemaking (assembling the parts).

When raw material for uppers was purchased, it was charged at cost to the proper sub-account under account 31. When bottom material whole stock was purchased it was charged at cost to account 32*A*. As bottom material cut stock was purchased it was charged at standard or predetermined allowance to account 32*C*, the purchase variation being accounted for through account 513, Loss or Gain on Purchases of Cut Stock. Bottom material cut stock was either purchased or cut in accordance with estimated requirements, although not for definite shoes entering into process.

At the time bottom material whole stock was cut, a report of the whole stock used and the product thereof was made to the Cost Department and figured therein, that is, the product was figured at standard or predetermined allowances and charged to account 32*D*, Cut Stock Cut. The whole stock was figured at cost and credited to account 32*B*, Transfers of Whole Stock to Cutting. The loss or gain on cutting, representing the difference between the cost of the whole stock used and the value of the

product, was taken care of through account 512, Loss or Gain on Cutting Bottoms. The reports of bottom material whole stock cut referred to above were summarized in the cost office in the Record of Sole Leather Cutting and at the close of the month this record formed the basis for an entry in the cost journal.

Upper material was cut to fill the requirements for specific shoes which had been put into process. Cutting tickets were issued to cutters with specific instructions relative to style and size of patterns to be used, and they were issued an adequate supply of leather from which to cut the quantities called for by the cutting ticket. On completion of the work the cutting tickets were forwarded to the cost office where the loss or gain in cutting was computed thereon and summarized in the Record of Upper Leather Cutting. At the close of every month this record formed the basis for an entry in the cost journal crediting account 31*F*, Transfers of Upper Material to Shoemaking, at actual cost and charging account 501, Upper Material Transfers, with the allowance value of the product. The loss or gain in cutting was handled through account 502, Loss or Gain in Cutting Uppers.

The company maintained a system of day sheets which were essentially scheduling devices and facilitated the movement of materials through the operating departments. The day sheets represented a day's production and were accompanied into the factory by manufacturing tags and labor coupon tags. The foremen of all operating departments received copies of all day sheets so that they were continually informed of the work which was in progress and could guide the activities of their departments accordingly.

As the finished shoes passed from the Packing Department to the Stores Department, the Packing Department's copy of the day sheet was forwarded to the Cost Department where it was recorded in the Analysis and Summary of Pairs Produced by Stock Number and Subclassification of Product. At the close of the month the shoes recorded from the day sheets in this summary of pairs produced were figured at standard or predetermined allowances for each of the elements of cost, and this record then formed the basis for an entry in the cost journal charging account 51, Work in Process, and crediting the Transfers to Work in Process accounts in the shoemaking division of the general ledger.

At the close of each month there were shoes in process as indicated by copies of uncompleted day sheets on file in the Cost Department. From these day sheets a record was made in the Analysis of Work in Process of the point of completion and a value for the Work in Process was determined. From the Analysis of Work in Process an entry was made in the cost journal debiting account 51, Work in Process, and crediting the Transfers to Work in Process accounts in the shoemaking division of the general ledger. An entry was then made in the cost journal debiting the finished goods account and crediting account 51, Work in Process, for the standard or allowed cost of shoes actually completed and transferred to stores during the month.

An entry was made monthly in the cost journal debiting or crediting account 255, Loss or Gain in Shoemaking, and debiting or crediting the Transfer to Loss or Gain in Shoemaking accounts in the shoemaking division of the general ledger. This gave effect to the variations between the aggregate balances in the panels of accounts in the shoemaking division of the general ledger, upper materials, bottom materials, direct labor, etc., and the amounts transferred to Work in Process. When this entry had been made, the accounts in the shoemaking division were in balance and the entire variation between actual cost and standard or allowed cost was set forth in account 255, Loss or Gain in Shoemaking.

As shoes were sold they were analyzed by the Cost Department in the Analysis and Summary of Shoes Sold and Shoes Returned by Stock Numbers and Subclassification of Product. At the close of the month the shoes recorded in this analysis and summary were figured at standard or allowed cost and an entry was made charging the proper cost of sales account and crediting the proper finished goods account.

Upon completion of these entries the monthly financial statements were prepared in which the figured gross profit was computed and the adjustment therein shown due to any loss or gain in shoemaking as reflected in account 255.

At the close of the company's fiscal year physical inventories were taken, and figured both at standard or allowed cost and at market. Comparison was made between the physical inventories at standard and the book inventories and the necessary adjustments were made in the books. The adjustments to market

were made through accounts 48 and 69, Reserves for Adjustment of Inventory to the Lower of Cost or Market. Adjustments of finished goods were taken care of through account 257 while adjustments of raw materials were handled through accounts 504 and 514.

Mr. Lane completed his investigation and believed that sufficient information had been acquired to begin the audit. After final arrangements were made with the client respecting the audit, Mr. Lane subsequently used his findings in the preparation of the following audit program:

Audit Program

A. Cash:

1. Count and prepare list of cash on hand, both petty and undeposited general cash.
2. Secure approval of any I.O.U.'s or vouchers in petty cash.
3. Deposit in bank cheques found in the cash count requesting advice of protest.
4. Compare cheques with Record of Cheques Drawn, examining signatures and endorsements.
5. Prepare reconciliation of bank accounts as of the close of the period and as of the close of business of the day prior to the start of the audit.
6. Prepare reconciliation of receipts and deposits, also a reconciliation of cheques drawn and cheques paid.
7. Obtain written confirmation from depositary banks of balances shown on bank statements and deposits in transfer.
8. Make a comprehensive test check of petty cash vouchers.
9. Verify footings (net cash, discount, allowances or other deductions) in Record of Cash Received.
10. Verify footings (net amount of cheques, discount or other deductions) in Record of Cheques Drawn.
11. Summarize Record of Cash Received analyzing miscellaneous or general ledger columns.
12. Summarize Record of Cheques Drawn, analyzing miscellaneous or general ledger columns.
13. Post summaries of Record of Cash Received and Record of Cheques Drawn to the transactions columns on the general ledger work sheet.

B. Notes Receivable:

1. Prepare sketch of Notes Receivable accounts.
2. Verify interest received on Notes Receivable.
3. Examine Notes Receivable on hand and verify, through correspondence, notes in for collection.

4. Look into the matter of whether or not the notes represent renewals.
5. Obtain written confirmation from the banks of Notes Receivable Discounted.

C. Accounts Receivable:

1. Check Accounts Receivable ledgers in detail against the trial balance.
2. List and age all accounts over sixty days old, or any other accounts which appear to be doubtful.
3. Review the doubtful accounts with the proper executive of the company and examine correspondence with the customers in connection with the slow accounts.
4. Check the adequacy of the Reserve for Bad Debts.
5. Examine accounts charged off during the period as worthless and discuss the same with the proper official.
6. Foot the Accounts Receivable trial balance and check against the general ledger controlling account.
7. Segregate the credit balances to be shown separately on the balance sheet.
8. Make a test check of charges to the accounts.
9. Make a test check of credits, other than cash, to the accounts and note that all such credits bear the approval of the proper official.
10. Separate Accounts Receivable from officers and employees.
11. Ascertain and verify Accounts Receivable from closely affiliated companies.

D. Inventories:

1. Obtain original inventory sheets.
2. Make a comparison of totals of subdivisions of inventory with controlling accounts in the general ledger, questioning and examining any unreasonable variation therein.
3. Make a test check of prices used in figuring raw materials and supplies by comparison with recent invoices.
4. Determine that all materials and supplies listed on the inventory are covered by purchase invoices which have been recorded.
5. Foot and summarize all inventory sheets.
6. Examine prices used in figuring finished shoes.
7. Discuss with the proper official the inventory as a whole and any questionable items in either raw materials or finished stock.
8. Make a comparison with the inventory at the beginning of the period.

E. Plant Accounts:

1. Examine titles.
2. Examine basis of valuation.

3. Sketch plant accounts and examine additions to or disposal of plant during the year, checking vouchers and other data or supporting entries.

4. Examine depreciation reserves at the beginning of year and additions thereto during the year.

F. Miscellaneous Assets:

1. Verify transportation claims by examination of claim record.
2. Analyze Suspense account.
3. Verify advances to salesmen by examination of salesmen's expense reports.

G. Deferred Charges:

1. List insurance policies by classes of risk and figure unexpired insurance—check adequacy of coverage.
2. Figure prepaid interest (see instructions under notes payable).
3. Sketch tax accounts, check vouchers and figure prepaid taxes.
4. Verify prepaid selling expense.

H. Notes Payable:

1. Sketch note accounts.
2. Examine paid notes.
3. Confirm liability at close of period through correspondence with banks, brokers and others.
4. Verify amount of interest paid.
5. Figure prepaid or accrued interest.

I. Accounts Payable:

1. Check trial balance against open items in Record of Audited Invoices and invoices in unpaid file.
2. Foot trial balance and compare with controlling account in the general ledger.
3. Examine receiving records and inventory to determine that all invoices applicable to the period have been recorded.
4. Examine statements from creditors if available at time of audit and, when considered necessary, correspond with creditors to ascertain correct amount owing.
5. Ascertain and verify amounts owed to stockholders, officers and employees.
6. Ascertain and verify accounts payable to closely affiliated companies.
7. Ascertain amount of debit balances in accounts payable.

J. Accrued Liabilities:

1. Ascertain that all accrued liabilities have been brought onto the books before closing and verify the same.

K. Dividend Accounts:

1. Make a sketch of the dividend accounts.
2. Examine minute book for authorization of dividends paid.
3. Verify dividends paid by comparison with list of stockholders.

L. Reserve Accounts:

1. Prepare sketch of, examine, and review all reserve accounts.
2. Determine adequacy thereof.
3. Examine minute book for authorization and determine that all reserves authorized have been provided.

M. Capital Stock:

1. List stockholders from stock ledger or stock certificate book.
2. Check all stock transfers during the period.
3. Examine cancelled certificates for endorsement, cancellation, State and Federal transfer stamps, etc.
4. Verify stock authorized, authorized to issue, issued and outstanding.

N. Surplus:

1. Prepare a sketch of the Surplus account.
2. Examine charges or credits thereto during the year.
3. Examine minutes for authorization of major charges or credits to Surplus account.

O. Sales and Miscellaneous Revenue:

1. Summarize record of sales and returns, as to both quantities and amounts.
2. Verify the footings of at least two months of the Record of Sales and Returns.
3. Scrutinize sales returns and note proper approval for credits to customers' accounts.
4. Make a test check of duplicate invoices against Record of Sales.
5. Make a test check of duplicate invoices against salesmen's or customers' orders, customers' confirmations, and shipping records.
6. Examine shipments at close of period to see that proper cut-off has been made and that no merchandise included in the inventory was billed and charged to customers prior to closing.
7. Post summary of Record of Sales and Returns to general ledger work sheet.

P. Purchases:

1. Summarize record of purchases and distribution.
2. Make test check of purchases in purchase record.
3. Make test check of invoices against purchase record, examining invoices for proper approval, receipt of merchandise and distribution.
4. Examine receiving records at the close of the period to determine that invoices have been recorded for all merchandise received.

5. Make proper inquiry relative to expense bills and note that bills for all expenses applicable to the year have been properly recorded.

6. Post summary of record of purchases and distribution to general ledger work sheet.

Q. General Journal:

1. Summarize.
2. Scrutinize carefully all entries therein.
3. Examine authorization and secure approval for those entries requiring same.
4. Post summary of general journal to general ledger work sheet.

R. Private Journal:

1. Summarize.
2. Scrutinize entries.
3. Examine authorization and secure approval of entries.
4. Post summaries to work sheet.

S. Cost Journal:

1. Summarize.
2. Scrutinize entries.
3. Post summary to work sheet.

T. General and Private Ledgers:

1. Draw off trial balance as of the beginning of the year in first pair of columns on work sheet.
2. Post summaries of books of original entry in second set of columns on work sheet.
3. Extend trial balance at close of the period in third pair of columns on work sheet.
4. Compare trial balance so extended with general and private ledgers.
5. Prepare necessary adjusting entries and post to fourth pair of columns on work sheet.
6. Extend adjusted trial balance in fifth pair of columns on work sheet.
7. Foot second pair of columns on work sheet and prove with totals of summaries on books of original entry.
8. Foot fourth pair of columns on work sheet and verify with totals of adjusting journal entries.
9. Analyze in detail the following accounts, indexing the same both on the analysis and on the work sheet:
    (*a*) Notes Receivable
    (*b*) Reserve for Losses from Bad Debts
    (*c*) Plant Accounts

(d) Suspense
(e) Notes Payable
(f) Dividend Account
(g) Reserve Account
(h) Capital Accounts
(i) Surplus Account
(j) Profit or Loss on Sale of Capital Assets
(k) Contributions
(l) Loss or Gain in Shoemaking
(m) Loss or Gain Adjusting Inventories—Finished Shoes
(n) Taxes
(o) Repairs
(p) Depreciation
(q) Official Salaries

U. Payroll:

1. Summarize totals of payroll record.
2. Verify summary by comparison with total of Accrued Payroll in Record of Audited Invoices and Record of Cheques Drawn.
3. Make test check of footings in payroll record.
4. Scrutinize salaries paid and verify with minute book.
5. Note loss or gain in absorption of direct labor in shoemaking (see account No. 539).
6. Prepare analysis of official salaries paid.

V. General:

1. Ascertain adequacy of insurance coverage.
2. Make inquiries relative to unfilled sales orders.
3. Examine purchase commitments.
4. Make inquiry relative to contingent liabilities.
5. Make inquiry relative to items omitted from the books.
6. Examine records of stockholders' and directors' meetings and make sketch of important votes, dates of meetings, and list of officers and directors.
7. Make a general review of cost records to determine the efficiency thereof.
8. Make a comparison of sales and production with budget and analyze variations therefrom.

W. Reports and Returns:

1. Prepare report to stockholders including the following exhibits and schedules:

   (a) Comparative Condensed Balance Sheets beginning and end of the period with increases and decreases indicated.
   (b) Detailed Balance Sheet as of the close of the period.
   (c) Trading and Profit and Loss Account in comparative form with the prior year.

(*d*) Statement of Loss or Gain in Shoemaking.
(*e*) Statement of Source and Application of Funds.
(*f*) Schedule of Notes Receivable.
(*g*) Schedule of Plant and Reserve for Depreciation Account.
(*h*) Schedule of Notes Payable.

2. Prepare Certified Balance Sheet and Condensed Income Statement.
3. Federal Income and Excess Profits Tax Return.

Compare this audit program with that outlined in "Examination of Financial Statements by Independent Public Accountants." Is this a balance sheet audit?

Does a summary of the books of account throw any light upon the probable audit requirements?

After studying the company's system of standard costs, would you recommend any changes?

13. ATCHISON SHOE COMPANY—No. 3

CONFIRMATION OF AUDIT AGREEMENT: WHAT PURPOSE IS SERVED BY THE CONFIRMATION OF AN AGREEMENT REGARDING SERVICES?

Mr. Lane, having concluded that the Atchison Shoe Company had a good system of accounts well kept and that a balance sheet audit was feasible, reported his finding to the office of Eaton, Fosdick & Company. Mr. Fosdick then sent the following letter to the Atchison Shoe Company:

St. Louis, Missouri
September 14, 1931

Mr. A. L. Ewald
14 Parker Street
St. Louis, Missouri

Dear Mr. Ewald:

Confirming our tentative agreement of September 10, 1931, we shall be pleased to undertake for you the following services:

(1) Complete verification of Assets and Liabilities as of October 31, 1931.
(2) Extensive Verification of Income and Expenses for Year Ended October 31, 1931.

(3) Preparation of
(a) Detailed Audit Report to Stockholders
(b) Certified Balance Sheets and Related Income Statement for Credit Purposes
(c) Federal Income Tax Return

Our services shall be rendered at the following per diem rates:

Senior Accountants	$30
Junior Accountants	15
Principals	A Reasonable Fee

We shall submit ten copies of our report to you not later than December 31, 1931.

The audit commencing November 15 will be under the supervision of Mr. P. C. Lane of our office.

Very truly yours,
EATON, FOSDICK & COMPANY
BY J. R. FOSDICK

Comment upon the sufficiency of this letter.

14. POMONA COMPANY

AUDIT PROGRAM: WHAT TYPE OF AUDIT PROGRAM MAY BE DESIGNED FOR A FRUIT STORAGE COMPANY?

In 1930, 200 apple growers in Ohio organized the Pomona Company, a corporation to store their product and that of other neighboring farmers who wished to use its facilities. Since this was a cooperative venture, each of the organizers bought and paid for one share of stock of $100 par value. With the $20,000 thus raised, the company bought a site, built and equipped a plant, and established a bank account of $3,000 for running expenses. A popular member of the group, who had lost a leg in the First World War, was chosen to manage the institution on a salary basis. He hired help; bought supplies; kept the records, using a system which a local public accountant helped him install, with the assistance of the daughter of one of the members (a girl who attended the commercial department of the local high school and later a college in the community); and collected storage charges at a rate per box per month. Rates were fixed at a figure which produced a

modest profit each year, practically all of which was declared and paid as dividends.

In 1935, Hiram East, who had but recently come into the Midwest and appeared to his neighbors to be a man of substance, was invited to buy the share of a deceased member and join the board of directors. He learned that no audit of the company had been made since it was formed. Therefore he refused to accept the responsibility until, as he said, "a check was made by an independent accountant." Since none of his fellows knew much of anything about the functions of such a person, it was agreed to leave the details of the work to him provided that the expense did not exceed $250. The manager was in favor of having the audit made in this way.

Since the local college gave business courses, Mr. East thought that he could get a satisfactory job done by a student in the auditing course at the institution at a relatively low rate. When he had selected one of the students for the work with the assistance of the instructor, he told him that he wished the audit to be made early in 1936, and that he wanted "a detailed check of the transactions of 1935."

Prepare a program for this audit.

As a result of carrying out this program what certified statements, if any, could the accountant furnish?

Would this audit be satisfactory for all usual purposes? If not, suggest possible changes, giving attention to the probability of the results justifying the cost.

15. HARVEY CHEMICAL COMPANY

INTRODUCTORY PROCEDURE: WHAT FORM OF STATEMENT CAN BE PREPARED TO ANALYZE THE CHANGES IN THE FINANCIAL POSITION OF A COMPANY?

During 1930 a new management had been able to put the Harvey Chemical Company on a profitable basis and to improve the working capital position materially. However, the cash position was not so strong at the end of the year as at the beginning

and in an effort to analyze the changes in financial position, the accountants who were auditing the books for the year ended December 31, 1930, compared the opening and closing balance sheets and studied the operating statement and statement of surplus for the intervening period, which statements are given on pages 202–204.

BALANCE SHEET
HARVEY CHEMICAL COMPANY
DECEMBER 31, 1929

ASSETS				
Current:				
Cash			$ 67,513.78	
Notes Receivable			3,634.97	
Accounts Receivable		$280,988.51		
Less: Allowance for Doubtful Accounts		10,000.00	270,988.51	
Merchandise Inventories			242,265.42	$ 584,402.68
Other Assets:				
Investments (Book Value)			$ 6,939.38	
Miscellaneous			7,833.07	14,772.45
Permanent:				
Land			$ 8,550.00	
Buildings	$164,974.78			
Machinery and Equipment	359,719.33			
Delivery Trucks	27,253.40			
Furniture and Fixtures	16,112.76	$568,060.27		
Less: Allowance for Depreciation		69,151.02	498,909.25	507,459.25
Patents				17,579.80
Deferred Charges				13,621.65
				$1,137,835.83
LIABILITIES				
Current:				
Bank Loans			$272,500.00	
Accounts Payable			191,868.65	
Accrued Accounts			8,812.29	$ 473,180.94
Capital:				
Capital Stock				
7% Cumulative Preferred Stock			$270,600.00	
Common Stock			250,000.00	
Surplus			144,054.89	664,654.89
				$1,137,835.83

NOTE "A": At December 31, 1929, dividends on the 7% cumulative preferred stock were in arrears in the amount of $28,406.00.

NOTE "B": No allowance for depreciation of permanent assets was made for the period from January 1, 1929 to December 31, 1929.

NOTE "C": At December 31, 1929, the Company was contingently liable as endorser on notes receivable discounted in the sum of $20,000.00.

Balance Sheet
Harvey Chemical Company
December 31, 1930

Assets				
Current:				
Cash			$ 39,658.01	
Notes Receivable			10,003.34	
Accounts Receivable		$321,493.72		
Less: Allowance for Doubtful Accounts		15,000.00	306,493.72	
Merchandise Inventories			363,790.16	$ 719,945.23
Other Assets:				
Investments (Book Value)			4,811.31	
Miscellaneous			460.29	5,271.60
Permanent:				
Land			$ 8,550.00	
Buildings	$173,219.68			
Machinery and Equipment	392,473.47			
Delivery Trucks	25,193.40			
Furniture and Fixtures	16,575.57	$607,462.12		
Less: Allowance for Depreciation		122,085.18	485,376.94	493,926.94
Patents				16,247.61
Deferred Charges				14,238.97
				$1,249,630.35
Liabilities				
Current:				
Bank Loans			$270,000.00	
Accounts Payable			162,142.30	
Accrued Accounts			10,572.28	
Provision for Federal Taxes			5,705.45	$ 448,420.03
Capital:				
Capital Stock				
7% Cumulative Preferred			$270,600.00	
Common Stock			250,000.00	
Surplus			280,610.32	801,210.32
				$1,249,630.35

Note "A": At December 31, 1930 dividends on the 7% Cumulative Preferred Stock were in arrears in the amount of $28,406.00.

Note "B": The Company was contingently liable as endorser on Customers' Notes Receivable discounted in the amount of $13,046.00.

Profit and Loss Statement
Harvey Chemical Company
For the Year Ended December 31, 1930

Net Sales				$2,244,045.14
Cost of Sales (including amortization of patents—$1,332.19)				1,784,123.92
Gross Profit				$ 459,921.22
General and Administrative Expense			$ 87,363.20	
Selling Expense			167,707.52	255,070.72
Net Profit from Operations (before depreciation)				$ 204,850.50
Depreciation				26,381.52
Net Profit from Operations				$ 178,468.98
Other Income				
Profit on Sale of Truck*			$ 320.00	
Deductions from Income				
Interest Paid	$15,857.75			
Less: Interest Earned	1,620.90	$14,236.85		
Bad Debts Written Off	$12,197.46			
Less: Recoveries	19.00	12,178.46		
State Taxes		379.57		
Loss on Sale of Securities**		917.91	27,712.79	
Net Deduction from Income				27,392.79
Net Profit before Federal Taxes				$ 151,076.19
Provision for Federal Taxes				5,705.45
Net Profit carried to Surplus				$ 145,370.74

* A truck which originally cost $2,060.00 on which depreciation amounting to $1,030.00 had been taken had been sold for $1,350.00.

** Securities carried on the books at $2,128.07 had been sold for $1,210.16.

Analysis of Surplus
Harvey Chemical Company
For the Year Ended December 31, 1930

Surplus, December 31, 1929			$144,054.89
Additions			
Net Profit for year ended December 31, 1930	$145,370.74		
Adjustment of damage claim	36,864.96		
Government of Germany claim recovered	673.03		
Refund Federal Taxes prior years	171.34	$183,080.07	
Deductions			
Dividend paid on preferred stock	18,942.00		
Depreciation for 1929	27,582.64	46,524.64	136,555.43
Surplus per Balance Sheet			$280,610.32

What statements can be prepared which would assist the auditors in their analysis?

What are the advantages of preparing such statements in tentative form at the beginning of the audit?

PART II

AUDITING PRACTICE AND PROCEDURE

CHAPTER IV

AUDIT OF CASH

1. SAGAMORE MILLS

CASH AUDIT: DOES KEEPING THE CASH BOOK OPEN AFTER DATE OF BALANCE SHEET COMPLICATE AN AUDIT?

The General Laws of the Commonwealth of Massachusetts[1] require that corporations shall submit annually to the Commissioner of Corporations a statement of assets and liabilities as of the end of the last fiscal year. One of the sections of the General Laws is given below:[2]

> Such report of a corporation which has a capital stock of $100,000 or more, for this purpose counting shares without par value as of a par value of $100 each, shall be accompanied by a written statement on oath by an auditor that such report represents the true condition of the affairs of said corporation as disclosed by its books at the time of making such audit. Such auditor shall be employed for each ensuing fiscal year by a committee of three stockholders who are not directors which shall be selected at each annual meeting of the stockholders, or, if there are not three stockholders other than directors able and willing to serve on such committee, he shall be employed by the directors; but no bookkeeper, treasurer or other officer of the corporation shall be appointed as such auditor. The statement of the auditor shall be filed by him with said report in the office of the state secretary and shall be attached to and form part of it. The auditor shall be duly sworn to the faithful performance of his duties, and the officers of the corporation who sign said report of condition shall certify thereon that the auditor was duly elected and qualified, as herein provided.

An auditor was employed to audit the accounts of the Sagamore Mills as of December 31, 1925, for the purpose of the statutory requirement just referred to. The auditor made a thorough examination and found that current assets and current liabilities shown on the books were as in the table on page 208.

As a result of his examination the auditor was prepared to approve each of the items stated thereon with the possible exception that he had discovered that the cash book was held open for one month after December 31, 1925, so that cash transactions of January, 1926, were recorded in the accounts as if those trans-

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[1] *General Laws, Commonwealth of Massachusetts*, Chap. 156, Sec. 47.
[2] *Ibid.*, Chap. 156, Sec. 49.

Current Assets:	
Cash	$ 166,055.70
U. S. Liberty bonds, at par	632,050.00
Accrued interest on U. S. Liberty bonds	5,182.65
Accounts receivable	406,692.23
Inventories	1,226,634.70
Current Liabilities:	
Accounts payable	657,619.58
Commissions accrued	8,873.65

actions had taken place in December, 1925. If the cash transactions of January, 1926, had not been entered on the books as of December, 1925, the accounts receivable at December 31, 1925, would have been represented in the ledger at an amount of $504,505.03 greater than the sum shown above; accounts payable would have been represented at an amount $440,508.41 greater than the sum shown above; and cash would have appeared in the ledger at an amount $63,996.62 less than the above figure.

The treasurer of the company explained to the auditor that since the business was founded, which was sixty years ago, the books had been held open for one month after the close of the fiscal year in order that the receivables and payables applicable to the season's business might be accounted for on a cash basis. The treasurer stated that he believed the books so kept were accurate, because they represented the transactions pertaining to each season's business at the amounts of the settlements in cash. Certainly, the treasurer argued, the books had been kept consistently from year to year. Moreover, the Massachusetts statute provided that the auditor should certify that the company's report represented the true condition "as disclosed by its books."

If you had been the auditor, what decision would you have made regarding the certification of the balance sheet, assuming that you had audited all the other assets and liabilities as well as the current assets and current liabilities?

What difficulty, if any, would the above practice cause an auditor?

2. KANE & COMPANY

AUDIT OF CASH: HOW COULD A CASH SHORTAGE BE DETECTED?

Kane & Company was a large investment banking and brokerage house. Large amounts of customers' checks were often received in the afternoon too late for deposit in the bank on that day. During the month of September, 1927, the cashier of the concern misappropriated the sum of $10,000 from the company's funds, but made no entry on the books to conceal the fraud.

Anticipating an audit of his accounts at the end of September, he attempted to cover the shortage of cash by omitting to enter in the cash book until October 1, a customer's check for $10,000. This check was received on September 30, and was deposited in the bank on that date by the cashier.

An auditing firm was engaged by Kane & Company to make a balance sheet audit of the accounts as of September 30, 1927. Kane & Company did not notify the auditing firm of their desire to have an audit until late in the day of September 30, and the auditors did not begin their work until the morning of October 1, which was a Saturday and a business holiday in that city because of a local anniversary.

What steps should the auditors have taken to discover the shortage?

Wherein would a balance sheet audit have differed from a detailed audit in this case?

3. AMBROSE STATIONERY STORE

PETTY CASH: HOW SHOULD PETTY CASH FUNDS BE AUDITED?

At the close of business January 31, 1935, the auditors began the verification of the accounts of the Ambrose Stationery Store.

They had previously obtained a list of the petty cash funds from the treasurer, and their first step was to count these funds. The amount of the funds and the count of cash on hand for each were as given below:

	Amount of Fund	Counted
Book Department	$ 35.00	$ 35.00
Stationery Department	35.00	35.00
Pen Department	35.00	35.00
Engraving Department	35.00	35.00
Office Furniture Department	30.00	40.50
Periodical Department	2.00	2.00
Shipping and Receiving Department	10.00	10.11
Cashier	250.00	113.37
Total	$432.00	$305.98

The $10.50 excess in the Office Furniture Department was on account of a sale made that morning. This fact was verified from the cash register tape and from the cumulative total. The 11 cents excess in the Shipping and Receiving Department was an overage in the fund. In the case of the cashier's fund, in addition to the $113.37, the auditors found cash vouchers to the amount of $154.72 as follows:

Advances on salaries	$ 63.00
December items held up temporarily by the manager	61.44
Voucher dated 3/8/33, for Periodical Department Change Fund	2.00
Items for January 28–31, 1935	28.28
Total	$154.72

The amount of these vouchers added to the cash made the cashier's fund $18.09 over. The cashier explained that part of the receipts of January 28, 1935, were withheld from the bank deposit and used for petty cash disbursements. The fund since having been replenished, the cashier intended to make an immediate deposit of $18.09.

The ledger account for Petty Cash showed a balance of $680.00. This figure was considerably above the total of the funds as given on the treasurer's list. To discover the discrepancy the auditors had to analyze the account back to 1922. They found in the first place, that there was a $50.00 debit to the Office Furniture Department. Of this amount, there was one $20.00 debit made in 1925. Although this subdepartment was discontinued in 1928, there was no credit in the Petty Cash account for this $20.00 fund. The

auditors assumed, therefore, that it must have been turned in together with the daily receipts when the department was discontinued.

There was also a special fund of $200.00 which was set up February 4, 1927. The manager thought that the envelope containing the vouchers covering this fund would be found, but the auditors were unable to locate it. They did find, however, two uncanceled checks for $71.05 and $71.54 signed by the Ambrose Stationery Store and payable to the manager and the assistant manager. These checks had been made out in 1928 to reimburse these men for expenses to a stationers' convention, and had been turned over to the store to cover the money advanced them from this $200.00 fund. The men objected to taking this money, but the treasurer had insisted. The matter had been temporarily laid aside and had never been settled since. The two checks were still listed among the outstanding checks in the regular checking account of the store.

While searching for the vouchers for this $200.00 fund, the accountants came upon a voucher for $20.00 dated March 6, 1929. By inquiry it was found out that at that time there was a $20.00 job in the engraving department which had just been completed but had not been called for. The cash for it was taken out of petty cash so as to close the books and yet include this sale. Though it was intended to reimburse the fund later, the $20.00 was never returned.

The Petty Cash account further disclosed that on February 2, 1934, there was a $10.00 fund set up in the name of the manager. The treasurer had forgotten this one in the list he prepared for the accountants. The manager also had not remembered it when asked by the auditors at the time of count whether he knew of any other funds. This $10.00 was counted about three weeks after the verification of the other cash. The auditors did not deem it necessary to count all the other cash over again at that time.

What journal entries should the auditors have made to adjust the Petty Cash account?

Did the auditors make a sufficient verification of the petty cash funds?

4. WING & COMPANY

RECONCILIATION STATEMENT: HOW WOULD YOU REVIEW A RECONCILIATION STATEMENT?

An accountant who had had less than two years' actual experience assisted in auditing the accounts of Wing & Company as of June 30, 1927. He prepared the following reconciliations of cash:

RECONCILIATION OF BANK BALANCE
JUNE 30, 1927

	Book	*Bank*
Balance at June 30	$10,275.01	$ 9,533.30
Outstanding checks June 30	1,928.71	
Deposits in transit as of June 30		2,684.63
June interest not entered on company books	13.81	
Deposited check understated on books of company in June	2.00	
Protested check charge not entered on company's books		1.60
	$12,219.53	$12,219.53

RECONCILIATION OF PAYMENTS
MONTH OF JUNE, 1927

Charges by bank as derived from bank statement for June:	
Balance May 31, per bank statement	$11,746.69
Add: credits during June, per bank statement	9,248.02
Total	$20,994.71
Deduct: balance June 30, per bank statement	9,353.30
	$11,641.41
Proof:	
Checks outstanding May 31 per company's books	$ 2,615.88
Add: checks drawn, per check register during June	10,773.84
	$13,389.72
Deduct: checks outstanding June 30	1,928.71
	$11,461.01
Adjustments to be added:	
Deposited checks charged back by bank—N.G.	75.00
Deposited checks returned—stop payment	105.00
Deposited checks understated in erroneous entry on books of company in June	2.00
	$11,643.01
Adjustments to be deducted:	
Protested check charge appearing on bank statement for June and not on the books of the company	1.60
Total as above	$11,641.41

Assuming that you were in charge of the audit, what questions should you have raised with the assistant in reviewing the foregoing reconciliations?

Prepare another reconciliation as you think it should have been.

5. JEFFERSON DISTRIBUTING COMPANY[1]

CASH: HOW CAN THE CASH ACCOUNTS BE AUDITED?

While auditing the books of the Jefferson Distributing Company for 1928, the accountants found cash on hand and in banks stated at $23,007.36 as of December 31. An analysis of the cash account revealed that the following items were included:

(a) Currency in cash drawer	$ 210.00
(b) Employees' I.O.U.'s	360.00
(c) Customers' checks dishonored and returned by bank	2,046.00
(d) Stamps held in cash drawer	42.00
(e) Bond coupons due but not presented for collection	480.00
(f) Cash at sales branches held as working funds	3,000.00
(g) Cash deposited in Jefferson Trust Company for certified check issued in payment of an account payable but not yet presented at bank	8,862.00
(h) Balance in Jefferson Trust Company as per company's check book, December 31, 1928	8,007.36
	$23,007.36

Further examination revealed that the company's check book balance of cash and the balance as given by the bank statement for December 31 were not in agreement. Check book figures for transactions during the month of December were as follows:

Check book balance, December 1, 1928	$ 7,741.44
Check No. 621	1,500.00
	6,241.44
Check No. 622	300.00
	5,941.44
Interest	134.70
	6,076.14
Deposit, December 5	3,584.70
	9,660.84
Check No. 623	6,000.00
	3,660.84
Deposit, December 7	3,151.80

[1] Adapted from Cole's *Problems in the Principles of Accounting*, No. 93, p. 94.

	$ 6,812.64
Deposit, December 11	4,268.28
	11,080.92
Check No. 624	24.00
	11,056.92
Deposit, December 15	2,201.94
	13,258.86
Check No. 625	4,207.50
	9,051.36
Deposit, December 24	2,464.68
	11,516.04
Check No. 626	150.00
	11,366.04
Check No. 627	2,500.02
	8,866.02
Check No. 628	358.68
	8,507.34
Check No. 629	300.00
	8,207.34
Check No. 630	199.98
Balance, December 31, 1928	$ 8,007.36

Transactions appearing on the bank statement for December were as follows:

Balance November 30, 1928	$ 9,337.56	Check	#618	$ 792.36
Deposit	4,126.08		#622	300.00
"	3,584.70		#625	4,207.50
"	3,151.80		#615	2,985.96
"	4,268.28		#619	179.70
"	2,201.94		#623	6,000.00
"	2,515.68		#621	1,500.00
Interest	15.00		#617	292.68
			#624	24.00
			#616	1,258.80
			#620	78.00
		Protest and Collection Chg.		1.50
		Check returned—no signature*		51.00
				$17,671.50
		Balance, Dec. 31, 1928		11,529.54
	$29,201.04			$29,201.04

* A check was deposited though lacking the signature of the customer and hence was returned and charged back.

Prepare schedules (1) reconciling the check book balance with the bank statement as of December 1 and (2) reconciling the bank statement with the check book figure of December 31.

At what figure should the cash be established on the balance sheet as of December 31? Substantiate your figure.

6. SLOANE MANUFACTURING COMPANY

CASH: WHAT ARE THE IMPLICATIONS TO BE DEDUCED FROM THE FIGURES?

The Sloane Manufacturing Company engaged a firm of public accountants to audit its books as of April 30, 1933. The auditors were informed in a preliminary interview that the treasurer acted as sales manager and as a result delegated many of his financial duties to the cashier. The cashier made all deposits and arranged for loans at the bank. At the end of each month he supplied the treasurer with a reconciliation of the bank balance and a condensed balance sheet. All checks and notes were signed by the cashier and countersigned by the treasurer. Because of his being away much of the time the treasurer countersigned a number of checks and notes ahead, trusting the cashier to issue them correctly.

The auditors discovered that the cashier had presented the following statements to the treasurer:

BANK RECONCILIATION—MARCH 31, 1933

Balance per bank statement		$ 8,451.29
Deduct—Outstanding checks	$16.21	
	24.19	
	14.29	54.69
Balance per cash book		$ 8,396.60

BANK RECONCILIATION—APRIL 30, 1933

Balance per bank statement		$25,272.78
Deduct—Outstanding checks	$48.95	
	64.29	113.24
Balance per cash book		$25,159.54

CONDENSED BALANCE SHEET—APRIL 30, 1933

Cash	$25,159.54	Accounts Payable	$10,421.98
Accounts Receivable	13,641.25	Notes Payable	10,000.00
Plant	37,262.39	Capital Stock	50,000.00
		Surplus	5,641.20
	$76,063.18		$76,063.18

The transactions appearing in the cash book and on the bank statement for the month of April were as shown below:

CASH RECEIPTS

Date	Debit Amount	Credit: Accounts Receivable	Credit: Miscellaneous
April 1	$ 456.20	$ 456.20	
	59.40	59.40	
	4.56	4.56	
4	3.21	3.21	
	48.25	48.25	
9	80.29	80.29	
	428.59	428.59	
	529.47	529.47	
15	641.19	641.19	
	892.41	892.41	
19	328.91	328.91	
	429 82	429.82	
	681.98	681.98	
25	824.92	824.92	
	729.83	729.83	
	624.47	624.47	
Loan	10,000.00		$10,000.00
28	422.91	422.91	
	329.14	329.14	
	116.24	116.24	
	$17,631.79	$7,631.79	$10,000.00
Balance—April 1, 1933	$ 8,396.60		
Receipts	17,631.79		
	$26,028.39		
Disbursements	868.85		
Balance—April 30, 1933	$25,159.54		

Cash Disbursements

Date	Credit Amount	Debit: Accounts Payable	Debit: Miscellaneous
April 5	$641.92	$641.92	
	28.94	28.94	
	19.83		$19.83
16	18.21	18.21	
	6.42		6.42
	19.84	19.84	
24	20.45	20.45	
28	48.95	48.95	
	64.29	64.29	
	$868.85	$842.60	$26.25

Bank Statement

Charges	Date	Deposits	Balance
$ 16.21, $ 24.19	April 1		$ 8,451.29
	2	$ 520.16	
$ 28.94	5	51.46	
	10	609.76	
$641.92, $ 14.29	11		
$ 19.83 $450.00	13		
$300.00	16	1,533.60	
$ 19.84, $ 6.42	21	758.73	
$ 18.21	24	860.57	
$ 20.45	26	Ln 12,000.00	
		179.22	
	29	868.29	
	30	Ln 1,000.00	25,272.78

Ln = Loan.

Show in detail the conclusions you draw from a study of the above figures.

7. HOWEL MANUFACTURING COMPANY

AUDIT OF CASH: HOW MUCH INVESTIGATION SHOULD BE MADE OF CASH IRREGULARITIES?

During the course of the annual audit in early 1938, a senior of Gallatin and Hamilton, certified public accountants, assigned one of his assistants to make the verification of the cash in banks. While Gallatin and Hamilton had been engaged to make a balance sheet examination, and not a detailed audit, it was their desire to be as helpful as possible to their client, within the limitations of their engagement, in protecting the company against misapplication of funds. Accordingly, Gallatin and Hamilton's senior instructed his assistant to keep this in mind in examining such cash and other bookkeeping entries as might fall within the scope of his work. It was learned that the company's cashier, who was an old and trusted employee, had full authority to sign checks. After a short time, the assistant assigned to the cash verification presented the senior with a reconciliation of the bank account, prepared in the usual manner, stating that the cash appeared to him to be in order.

Upon reviewing the assistant's working papers, the senior learned that, although he had reconciled the bank balance as at December 31, 1937, and verified the footings of the cashbook for the month of December, 1937, he had not compared the total receipts and disbursements, as shown by the cashbooks, with the deposits and withdrawals, as shown by the December bank statement. A reconciliation of these amounts disclosed that the debits and credits reflected in the bank statement exceeded by $7,500 the receipts and disbursements respectively shown in the cashbooks.

Upon further investigation it was found that $5,000 of this difference could be accounted for by the fact that a note for that amount payable to the bank was due in December and was paid by the company by check on the due date. Debit and credit slips included with the December canceled checks indicated that, prior to receipt of the check, the bank had charged the company's account with the amount of the maturing note, and that this charge had been subsequently offset by a credit. No explanation of the remaining $2,500 difference was readily available. However, expressing a desire to be helpful and to cooperate in expedit-

ing the auditors' examination, the company's cashier informed the senior that in recent months the bank had made frequent errors in posting to bank statements, and that "this difference is probably just another bank error." He also reassured the senior by calling attention to the fact that the existing debit was offset by a corresponding credit, so that the balance was not affected.

During the further review of the assistant's work, the senior learned that in an effort to speed up the work, no examination of payees' endorsements on canceled checks had been made. The reason given for this omission was that the assistant considered the examination of endorsements a waste of time, since he was not familiar with the payees' signatures and that, in addition, most of the checks were endorsed with rubber stamps. The senior reexamined the canceled checks and found one, amounting to $500, payable to one of the company's regular out-of-town suppliers of raw materials, endorsed in ink and bearing the second endorsement of the client's cashier. Upon inquiry the cashier stated that he had cashed the check out of the petty cash fund for the traveling representative of the supplier and was required by the bank to add his endorsement when he presented it to the bank himself for reimbursement.

In scrutinizing the bank's perforations of the December checks, which were presented to the senior by the cashier, the senior noted that one for $100 evidently was cashed by the bank in November. An investigation disclosed that the date and serial number on the check had been altered, and that no check of that amount had been included in the list of outstanding checks as at November 30.

In view of the facts outlined, would you consider it necessary to make any further investigation of the $2,500 difference referred to? If so, give your reasons and state briefly what procedure you would follow.

Would you consider it necessary to make any further investigation of the check made to the order of the supplier of raw materials which bore a second endorsement of the client's cashier? If so, what procedure would you follow?

With reference to the investigation of the bank perforations and check serial numbers, state briefly what might be accomplished through such a substitution of canceled checks.

8. BRAINARD SHOE COMPANY

AUDIT OF BRANCH CASH: WHAT TYPE OF REPORT SHOULD BE MADE ON A BRANCH CASH AUDIT?

Mr. Ralph B. Brainard, the president of the Brainard Shoe Company, engaged John P. Simmons, a public accountant, to audit the books and records of the Brainard Shoe Company for the year ended December 31, 1934. Among other things Mr. Simmons learned that the company had a branch retail shoe store in a distant city and that the only authorized financial transactions there were the receipt and deposit of cash received from cash, time and C.O.D. sales, the payment of all branch expenses, and the remittance of excess funds to the factory. Monthly reports of receipts and disbursements were sent to the factory by the branch.

In order to check up on conditions at the branch, Mr. Simmons wrote a friend of his, Mr. Raymond D. Lee, a certified public accountant who had an office in the city where the branch was located, the following letter:

Dear Ray,

Please undertake for me the following work at your usual rates:

(1) Compare the twelve monthly cash reports for 1934 of the Brainard Shoe Company's branch in your city with the records kept at the branch. The monthly cash reports are going forward to you today under separate cover.

(2) Audit the branch records.

Very truly yours,
JOHN

Mr. Lee reported to Mr. Simmons that the monthly reports agreed with the records and that the balance which, according to the records, should be in the bank had been confirmed directly to him by the bank. He stated, however, that the deposits as shown by the bank statements were in excess of the receipts shown on the records, and that the checks issued by the branch and charged on the bank statements, together with other charges on the bank statements exceeded the recorded disbursements. These excesses, he said, washed out. Included in his report, without further comment, was the following schedule of disbursements not appearing on the branch records.

	Checks for Bank Loans	Checks to Employees	Checks Returned to Branch and Later Redeposited	Checks for Accommodation Purchases
January.....	$ 3,500	$ 50	$ 50.00	
February....				
March.......			74.56	
April........	3,500 (renewal)	100		
May........			93.20	$150
June........				
July.........	3,500 (renewal)	75		
August......			24.50	175
September...				
October......	3,500 (renewal)	225	72.81	
November...	4,000	150	91.80	
December....				200
	$18,000	$600	$406.87	$525

Explain the meaning of each of the four classes of items in this schedule and state what contra items would cause the items in each of these four classes to wash out.

Criticize the instructions given by Mr. Simmons to Mr. Lee and the report of Mr. Lee.

Discuss the changes which should be made to handle the affairs of the branch more efficiently.

9. HAMERSLAG COMPANY

AUDIT OF CASH: HOW CAN DEFALCATIONS BE PREVENTED?

In September, 1937, Mr. R. L. Hamerslag, president of the Hamerslag Company, a wholesale grocery distributor, engaged Holbrook and Gray, public accountants, for a special investigation. A series of defalcations had been discovered in the work of A. K. Baxter, a recently discharged employee. Upon investigation, there was reason to believe that there had been collusion between Baxter and M. S. Jaynes, an employee of Filling Stations, Inc., from whom the 60 salesmen of the Hamerslag Company purchased gas and oil on a company charge account for their company-owned cars.

Mr. Hamerslag requested a complete investigation of the matter by Holbrook and Gray and a report incorporating their conclusions as to:

1. Whether carelessness or neglect of duty on the part of any other employee had contributed to the successful operation of the fraud.
2. Whether opportunities for defalcation had been presented by faults in the system used in the company.
3. What steps should be taken to prevent a recurrence without incurring additional expense to the company.

The following information was gathered by the staff employees of Holbrook and Gray during the course of their investigation.

1. Duties of A. K. Baxter, the employee who was responsible for the defalcation:
   a. To verify all monthly statements received from vendors, insofar as they related to expenses for automobile supplies. This included checking of all individual charge slips submitted by the vendors against the monthly statements and comparison of the charge slips with the duplicates sent in by the salesmen with their weekly expense reports.
   b. To maintain individual cost records for all cars, showing total monthly and per mile costs of each car by items (*i.e.*, gas, oil, repairs, tires, etc.).
   c. To supervise the maintenance of all company-owned cars and make recommendations for purchases of replacement equipment such as tires, batteries, etc. All such purchases were made, however, by the company purchasing agent.
2. Office procedure for handling the items involved:
   a. All monthly statements from vendors were verified against the detailed bills by the department in which the purchases originated, and, except in the case of large volume routine bills (such as the statements of Filling Stations, Inc., which included from 1,500 to 2,000 charge slips per month), by the company purchasing agent.
   b. After the departmental verification, all statements were approved by the office manager before the check was drawn.
   c. All routine checks were signed by the office manager and one officer of the company.
   d. All statements from vendors were subject to check by the company's auditing department which made a detailed audit of the books each month. However, it was decided in 1932 by the head of the auditing department and the office manager, with the approval of the president, that the volume of work involved in the making of a second check on certain large routine statements, including that of Filling Stations, Inc., would necessitate the hiring of additional help in the

auditing department and that the extra expense would not be justified so that such verifications were omitted.

e. All incoming mail was opened and stamped to show date and time of receipt, by the assistant office manager. Because of the volume of slips accompanying the statements of Filling Stations, Inc., and certain other vendors, only the statement was so stamped while the slips were turned over directly to the proper department for checking.

3. Method by which the defalcation was accomplished:

a. Baxter presented to M. S. Jaynes, manager of a service station of Filling Stations, Inc., charge slips to which he signed the names of the two or three Hamerslag salesmen who served adjacent territories. Jaynes substituted the forged slips for cash in his daily receipts.

b. When the monthly statement was received by Baxter, he removed and destroyed the forged slips and substituted therefor genuine slips from prior months in equal amounts, on which he changed the dates to the current month.

c. Baxter redistributed the excessive charges against the cars of the two or three salesmen concerned against all cars so that none was suspiciously out of line and costs per car were not excessive. Examination of the quarterly financial reports of the company for the three-year period during which defalcation occurred showed no suspiciously large balances in the automobile expense account, which was the only account in the general books of the company covering such expenses.

On the basis of the information presented, prepare, in outline form, the report to Mr. Hamerslag which you would be willing to sign as a partner of Holbrook and Gray.

10. WILSON AND COMPANY

CASH: HOW MAY EMBEZZLEMENT BE DETECTED?

In 1928, L. R. Jennings, cashier in the main office of Wilson and Company, a brokerage firm, confessed to defalcations over a period of years aggregating $164,650. During the period involved, Wilson and Company maintained about 13 bank accounts, five of which were in Chicago, where the main office was located. The company had about 1,200 customers' accounts, a large volume of daily transactions, and substantial bank loans. Many of the company's records were kept in the cashier's office, where he had complete charge. For instance, Jennings determined when and in what amounts to transfer funds from one bank to another.

His embezzlements, from about 1919 to 1928, consisted of abstractions from petty cash. The shortage at the banks was concealed by delaying and substituting bank deposits from day to day and, when an audit was made yearly, by "kiting" checks from one bank to another on the audit date. Jennings, of course, knew when audits were to be made and, by the use of this system, concealed his steadily increasing thefts.

It was Jennings' practice to take the "kiting" checks from the check books of the firm, but out of numerical order so that the stubs pertaining to the checks would appear beyond the last stub regularly dated for the month. Then, when the check stubs for the previous months were totaled in the check books, the "kited" checks would not be included in the footings for that month.

In the matter of late deposits, a deposit was often constituted differently than reflected in the books of the firm. For example, the deposit book would disclose the deposit of several individual items, and although the total sum would be deposited in the bank, it would consist of a different number of checks in different amounts and usually drawn by different makers. This practice developed because it was part of Jennings' system to place a customer's check in the petty cash box, instead of immediately depositing it, then extract from the petty cash the amount of that check in cash, and deposit the check in the bank one or more days later. The accumulating shortage in that bank would then be covered by the deposit of a check or checks drawn on another of the firm's banks for the amount necessary to conceal the shortage. At times Jennings would make up the aggregate of the shortage by depositing his own check along with the checks of others.

Memoranda were prepared in pencil by the bookkeeping department which were intended to show daily bank balances or the cash totals which the firm was supposed to have in banks. These memoranda were given to Jennings, who would change the amounts so as to reflect approximately the actual amount of cash in banks. However, these slips were not permanent records. They were information memoranda used solely for the consideration of bank loans.

What is meant by check "kiting"?

What should the auditors have done to detect this embezzlement in the course of an ordinary balance sheet audit?

11. LYDWELL COLLEGE FUND—No. 1

CASH ACCOUNTS: WHAT PROCEDURE SHOULD BE FOLLOWED IN VERIFYING TRUSTEES' CASH ACCOUNTS?

The Lydwell College Fund was an endowment fund, the income of which was used to help deserving students from the town of Blackwell to pay their way through college. It was originally started in 1903 by Mr. Lydwell, but since then many other people had added to the fund. Most of these additions had been in the form of cash and small pieces of land. The management of the fund was in the hands of a board of trustees of which the treasurer was the active head. He took the responsibility for collecting the rentals and income from securities, for paying the expenses, for buying and selling securities, and for keeping the records.

For cash, there were two bank accounts, one in the Commercial Trust Company and the other at the Blackwell Savings Bank. The first bank account was used for income cash only; the second, for capital cash. The two bank accounts were kept on the theory that there was likely to be a small amount of capital cash which could not be invested in securities, and as this cash should be earning interest at as high a rate as possible, it was kept in a savings bank. There was need of a checking account, also, in order to take care of current revenue and expense. The accounting record kept by the treasurer was a small bound book in which were noted all the cash transactions, the capital and income cash accounts being listed in separate columns. On the whole, the Trustees' Accounts were rather inaccurate as is shown by the following quotations from the auditors' report for December 31, 1925:

According to the Trustees' Accounts the capital cash was $65.05. The reconciliation of the Endowment Fund and the Endowment Fund Assets (this included securities, real estate and cash) could not be accomplished using this figure. Upon investigation, it was found that at the time of change of treasurers and the decision to use the Blackwell Savings Bank as a current depositary, a balance in the savings bank at that time was overlooked. In addition, the interest income on the savings account was overdrawn at various times and accrued interest on new bonds purchased for the Endowment Fund was paid from capital cash. Correction of these errors showed the following situation: The capital cash on hand December 31, 1925, was $177.04, of which $171.37 was in the Blackwell Savings Bank and $5.67 in the income

account in the Commercial Trust Company. The reconciliation of the cash portion of the Endowment Fund Assets is as follows:

Cash in Blackwell Savings Bank per bank certificate December 31, 1925		$171.37
Cash in Commercial Trust Company (Trustees' Income Account):		
Overdrafts of Savings Bank Interest	$5.65	
Prepaid Interest on Securities paid out of Capital	.02	5.67
		$177.04

. . . The balance at the Commercial Trust Company was, according to the Trustees' books and actually, $149.12, but of this $5.67 was capital.

The auditors' working papers showed further that the overdraft of $5.65 was made up as follows:

Income Cash at Commercial Trust over by:		
Amount withdrawn erroneously from capital cash and deposited in income cash account, January 18, 1911		$29.37
Accrued interest on bonds purchased, withdrawn from capital account, April 30, 1925	$11.70	
Less: Transfer from income cash account to capital cash account, May 21, 1925	1.66	10.04
Total Income Cash to be Transferred to Capital Cash		$39.41
Capital Cash at Blackwell Savings over by:		
Interest on Blackwell Savings account not transferred to Income Cash:		
July 10, 1920	$ 2.05	
January 10, 1921	1.18	
January 10, 1923	11.61	
July 10, 1923	2.90	
January 10, 1924	2.25	
January 10, 1924 to July 10, 1925. This is the difference between pass book balance as of December 31, 1925, and the balance as certified by Blackwell Savings Bank for that date	13.77	33.76
Net amount in Commercial Trust account that belongs in Blackwell Savings account		$ 5.65

The bank statement of the Commercial Trust Company for December, 1927, showed a balance of $2,860.55. The reconciliation for that date listed checks for $2,265.00, $57.75, and $525.00 as still outstanding. The first two were made to transfer funds to the Blackwell Savings Bank account. They were never used and finally were canceled in March, 1928.

Transcripts of the Blackwell Savings Bank pass book and the accounts in the Trustees' books for both the bank accounts are given in the accompanying tables.

TRUSTEES' BOOKS
COMMERCIAL TRUST COMPANY

Month	Day	Year	Description		Debit	Credit
April	1,	1925	Balance		$ 11.12	
July	8,	"	Standard Diary dividend.............		88.00	
Oct.	28,	"	City of Blackwell—taxes and water...			$ 600.00
Oct.	30,	"	Store rentals collected...............		650.00	
Jan.	6,	1926	Standard Diary dividend.............		88.00	
Jan.	6,	"	Commercial Trust—safe-deposit box for rental.........................			5.00
Jan.	12,	"	Store rentals collected...............		1,370.00	
Jan.	12,	"	Paid out to students.................			1,600.00
March	10,	"	Coupons on Utica Gas & Electric Bonds sold		52.50	
Feb.	4,	"	Coupons cashed.....................		1,231.50	
April	24,	"	Total deposit.................	$139.34		
			Transferring amount deposited in Blackwell Savings Bank and credited above 3/10.....	52.50		
			Balance to be credited........		$ 86.84	
			Coupons 3/1/26..............	$ 62.50		
			Interest credited by Blackwell Savings Bank not previously transferred to income account			
			To 1/10/23.........$11.61			
			To 7/10/23......... 2.90			
			To 1/10/24......... 2.25			
			To 1/10/26......... 17.62			
			$34.38			
			Less amount credited above 5/21/25........ 10.04	24.34		
				$86.84		
April	26,	"	Store rentals collected...............		900.00	
May	10,	"	Store rentals collected...............		200.00	
April	27,	"	Coupons cashed.....................		28.00	
May	22,	"	Paid out to students................			2,500.00
May	26,	"	Transfer to Blackwell Savings to cover accrued interest on Akron, Canton and Youngstown bonds............			9.40
April	27,	"	Coupons cashed.....................		70.00	
June	24,	"	Standard Diary dividend.............		88.00	
Nov.	1,	"	Store rentals collected..............		500.00	
Nov.	4,	"	City of Blackwell—taxes and water...			614.40
Dec.	30,	"	Standard Diary dividend............		88.00	
Jan.	7,	1927	Commercial Trust—safe-deposit box..			5.00
Feb.	21,	"	Estate of Truman Creswell bequest...		500.00	
March	19,	"	Coupons cashed		1,342.00	
April	9,	"	Paid to students.....................			4,101.78
April	11,	"	Blackwell Savings Bank—transfer of Truman Creswell bequest..........			500.00
June	4,	"	Mr. Burgess, Treasurer—for stamps..			.88
June	30,	"	Interest—Commercial Trust..........		7.95	

TRUSTEES' BOOKS
COMMERCIAL TRUST COMPANY (*Continued*)

				Debit	*Credit*
June	30,	1927	Store rentals collected	$ 2,620.00	
June	30,	"	Interest credited on Blackwell Savings Bank account—transferred	13.67	
May	31,	"	Store rentals collected	160.00	
June	24,	"	Coupons cashed	70.00	
June	24,	"	Coupons cashed	187.50	
June	27,	"	Interest on Commercial Trust account.	1.42	
Aug.	16,	"	Paid to students		$ 400.00
Oct.	19,	"	Interest on mortgage held	99.00	
Oct.	31,	"	Store rentals collected	610.00	
Nov.	2,	"	Coupons cashed	503.50	
Nov.	1,	"	City of Blackwell (taxes and water)		726.80
Nov.	4,	"	Paid to students		500 00
Nov.	11,	"	Adirondack Power & Light, 6s called at 106½ September 1, 1927, cost $845.00	1,065.00	
Nov.	11,	"	Goodyear Tire & Rubber 8s called at 120 November 1, 1927, cost $1,165.00	1,200.00	
Dec.	2,	"	Store rentals collected	590.00	
Dec.	6,	"	To transfer funds to Blackwell Savings		2,265.00
Dec.	6,	"	To transfer funds to Blackwell Savings		57.75
Dec.	6,	"	Paid to students		525.00
Dec.	27,	"	Interest on Commercial Trust Company account	1.81	
Dec.	31,	"	Balance		12.80
				$14,423.81	$14,423.81

BLACKWELL SAVINGS BANK PASS BOOK

Date	Deposited	Interest	Withdrawn	Balance
May 2, 1925	$ 1.66			$ 157.60
Jan. 11, 1926		$17.62		175.22
March 10, 1926	1,620.00			1,795.22
April 24, 1926			$ 76.84	1,718.38
May 11, 1926	Remitted		1,416.88	301.50
June 3, 1926	9.40			310.90
Jan. 10, 1927		13.67		324.57
May 18, 1927	Remit C & B		2.52	322.05
April 9, 1927	Order		13.67	308.38
April 9, 1927	$ 500.00			808.38
June 2, 1927	2,530.00			3,338.38
June 7, 1927	20.00			3,358.38
June 7, 1927	Order		3,357.75	.63
Mar. 20, 1928	$200.00 check			200.63

TRUSTEES' BOOKS
BLACKWELL SAVINGS BANK

		Debit	Credit
April 1, 1925	Balance ....$	65.05	
March 10, 1926	Proceeds from Utica Gas & Electric Bonds $1,500 called at 104½, Cost $1,485.00	1,567.50	
April 1, 1925	Cash on hand not shown on account above on this date................	85.83	
March 31, 1926	Transfer of Truman Creswell bequest.	500.00	
May 11, 1926	National City Corporation—1,500 Akron, Canton & Youngstown R. R., at 94, 5½% due April, 1945.......		$ 1,410.00
	Interest accrued 1 month to 5/1......		6.88
May 14, 1926	Interest accrued to 5/11............		2.52
May 26, 1926	Blackwell Savings Bank—to cover interest items above which belong in income account..................		9.40*
June 2, 1927	Sale of 22 shares of Standard Diary Stock at 115. Originally recorded at $105 per share...................	2,530.00	
June 7, 1927	Advance from Mr. Lord, Trustee, in the Treasurer's absence to cover funds withdrawn..................	20.00	
June 7, 1927	Payment for Blaine Street mortgage purchased from Ellsworth Stevens..		3,300.00
June 7, 1927	Accrued Interest on above mortgage...		57.75
Dec. 7, 1927	Reimbursement from income account for accrued interest paid June 7, 1927	57.75	
Dec. 6, 1927	Refund to Mr. Lord, Trustee, on account of advance made June 7.....		20.00
Dec. 31, 1927	Balance		38.38
		$ 4,826.13	$ 4,826.13

* Figures in red.

What procedure would you follow in auditing these cash accounts?

Assuming that the bank certificates agreed with the bank statement and pass book, at what figure should each of these cash accounts appear on the balance sheet for December 31, 1927?

12. HOPKINS DEPARTMENT STORE[1]—PART I

ANNUAL AUDIT: HOW WOULD YOU AUDIT THE BOOKS OF THE HOPKINS DEPARTMENT STORE FOR THE YEAR ENDED DECEMBER 31, 1927?

The Hopkins Department Store was located in New Rochelle, New York. It was a store of medium size and carried a conservative line of clothing and furnishings, furniture, hardware, stationery, china, books, toys, sporting goods, luggage, and piece goods. The following departments were maintained:

Department 1. Men's Clothing.
Ready-to-wear suits and coats for men and youths.
Department 2. Men's Furnishings.
Shirts, collars, ties, hats, socks, underwear, and hand luggage.
Department 3. Women's Clothing.
Dresses and coats.
Department 4. Women's Apparel.
Gloves, scarfs, stockings, hats, underwear, jewelry.
Department 5. Children's Apparel.
Complete outfits for boys, girls, and infants, except shoes.

[1] This problem is the first of a series of problems pertaining to the Hopkins Department Store, the whole series covering all the various aspects of a balance sheet audit. All of the schedules worked up on each problem should be saved and filed together so that when the last problem of the series is given the working papers will be complete and available to aid in the writing of the report to the client.

Hopkins Department Store
Balance Sheet as of December 31, 1926
Assets

Current:			
Cash in Bank		$ 18,397.96	
Petty Cash		1,050.00	
Accounts Receivable	$100,624.73		
Less: Reserve for Doubtful Accounts	6,183.49	94,441.24	
Inventories, at Approximate Cost		191,200.70	$305,089.90
Fixed:			
Land		$ 58,400.00	
Buildings	$366,503.05		
Less: Reserve for Depreciation	13,993.75	352,509.30	
Equipment	$ 49,224.81		
Less: Reserve for Depreciation	3,498.44	45,726.37	
Fixtures	$ 77,346.54		
Less: Reserve for Depreciation	13,759.63	63,586.91	
Automobiles	$ 3,856.28		
Less: Reserve for Depreciation	1,060.95	2,795.33	523,017.91
Deferred Charges:			
Insurance Unexpired		$ 5,301.40	
Taxes Prepaid		1,842.50	7,143.90
			$835,251.71

Liabilities and Capital

Current:			
Notes Payable		$ 20,000.00	
Accounts Payable—Merchandise		55,367.28	
Accounts Payable—Expense		3,170.32	
Interest Payable Accrued		522.77	
Customers' Deposits		1,500.00	
Provision for Income Taxes		12,000.00	$ 92,560.37
Funded Debt:			
Mortgage Notes Payable			
First Mortgage, Due 10/1/29	$250,000.00		
Second Mortgage, Due 10/1/29	47,500.00	$297,500.00	
6% Debenture Bonds			
Due May 1, 1927	$ 2,000.00		
Due November 1, 1931	40,000.00	42,000.00	339,500.00
Capital Stock			100,000.00
Surplus Reserves:			
Reserve for Contingencies		$ 65,501.86	
Reserve for Employees' Pensions		26,480.69	91,982.55
Surplus			211,208.79
			$835,251.71

Department 6. Shoes.
Men's, women's, and children's shoes, rubbers, overshoes, and boots; shoe laces, buckles, shoe polish.

Department 7. Furniture.
House, porch, and garden furniture, refrigerators, rugs, trunks, curtains.

Department 8. Stationery.
Stationery, pens, drugs, perfumes, books, candy, cigars.

Department 9. Hardware and Sporting Goods.
Tools, household hardware, china, kitchenware, sporting goods, toys, silverware, cameras, paints.

Department 10. Piece Goods.
Cloth yardage of all kinds, ribbons, novelties, thread, buttons.

Department 11. Special Order.
Goods not stocked.

The December 31, 1926, balance sheet, as prepared by an auditor, is given on page 231.

Assume that you were employed to audit the books of the Hopkins Department Store for the year 1927 and that the office manager handed you on February 6, 1928, the following preclosing trial balance taken from the general ledger as of December 31, 1927:

Trial Balance, December 31, 1927

Page	Account	Dr.	Cr.
A– 1	Cash in Bank	$ 62,157.14	
2	Petty Cash	1,050.00	
3	Accounts Receivable	113,859.94	
B– 1	Taxes Prepaid	5,643.30	
2	Insurance Prepaid	4,440.19	
3	Advanced Salaries	200.00	
C– 1	General Fixtures	23,317.95	
2	Men's Clothing Fixtures	3,013.48	
3	Men's Furnishings Fixtures	12,379.65	
4	Women's Clothing Fixtures	4,984.47	
5	Women's Apparel Fixtures	13,372.96	
6	Children's Apparel Fixtures	3,197.39	
7	Shoe Department Fixtures	2,412.34	
8	Furniture Fixtures	201.66	
9	Stationery Fixtures	5,432.17	
10	Hardware Fixtures	7,765.54	
11	Piece Goods Fixtures	6,917.77	
12	Automobiles	3,756.32	
	Forwarded	$ 274,102.27	

TRIAL BALANCE, DECEMBER 31, 1927 (*Continued*)

Page	Account	Dr.	Cr.
	Brought forward	$274,102.27	
D- 1	Accounts Payable—Merchandise		$53,096.07
2	Accounts Payable—Expense		2,651.95
3	Customers' Deposits		2,050.00
4	Notes Payable		10,000.00
E- 1	Building	367,077.15	
2	Land	58,400.00	
3	Equipment	51,396.74	
4	Mortgage Note Payable—First		250,000.00
5	Mortgage Note Payable—Second		37,500.00
F- 1	Reserve for Doubtful Accounts Receivable		5,104.00
2	Reserve for Contingencies		65,501.86
3	Reserve for Depreciation of Fixtures		22,652.39
4	Reserve for Depreciation of Automobiles		1,545.78
5	Reserve for Depreciation of Building		21,128.18
6	Reserve for Depreciation of Equipment		5,079.46
7	Reserve for Employees' Fund		27,804.92
8	Reserve for Payment of Funded Indebtedness		60,000.00
G- 2	Capital Stock		100,000.00
3	6% Debenture Bonds		40,000.00
4	Surplus		107,508.16
H- 1	Interest Received		1,128.84
2	Merchandise Discount		14,457.93
3	Interest on Merchandise Investment		10,003.25
4	Other Income		970.14
I- 1	Interest Expense	16,899.73	
2	Total Purchases	818,049.09	
	Inventories, December 31, 1926:		
3	Men's Clothing	14,675.34	
4	Men's Furnishings	15,893.77	
5	Women's Clothing	19,072.65	
6	Women's Apparel	21,534.44	
7	Children's Apparel	6,253.40	
8	Shoes	27,871.55	
9	Furniture	12,254.18	
10	Stationery	30,565.94	
11	Hardware and Sporting Goods	8,768.56	
12	Piece Goods	34,310.87	
K- 1	Total Sales		1,393,869.47
L- 1	Total Expenses	435,950.68	
2	Depreciation Expense	18,976.04	
		$2,232,052.40	$2,232,052.40

The following list of inventories as of December 31, 1927, was also given to you:

Department	Amount
1—Men's Clothing	$ 17,877.25
2—Men's Furnishings	19,472.65
3—Women's Clothing	23,416.47
4—Women's Apparel	26,392.18
5—Children's Apparel	7,828.57
6—Shoes	23,651.26
7—Furniture	10,518.62
8—Stationery	32,560.92
9—Hardware and Sporting Goods	8,410.13
10—Piece Goods	34,540.84
Total	$204,668.89

Prepare a work sheet showing the working trial balance.[1]

[1] This working trial balance consists of the book figures of accounts before any corrections have been made by the auditor. The work sheet constitutes a starting point and a master schedule which contains a panoramic picture of the audit upon its completion. It should contain at least six columns: the first two columns contain book figures of the company's accounts, the next two columns are used for adjustments, and the final columns reflect the adjusted book figures from which the certified statements are prepared. If desired, the work sheet may contain additional columns for adjusted profit and loss and adjusted balance sheet figures.

To facilitate the work of an auditor and afford a permanent record, schedules of each item are prepared. Each account on the working trial balance is assigned a symbol, the assets usually having a single letter, and liabilities a double letter, *e.g.*, Cash, A; Accounts Payable, AA. Schedules for these accounts showing the beginning book figures, necessary adjustments, and the final adjusted figure are prepared in detail together with adequate explanation of the work done by the auditor and are cross-indexed to the working trial balance and other schedules embracing the same adjustment. Subsidiary schedules denoting subdivisions of cash account and the other accounts are also prepared and are given prime numbers of the summary schedule letter. For instance, the summary schedule of cash, summarizing the supporting cash schedules would be A; petty cash would be A1; cash on hand, A2; cash in bank, A3, etc. until all subdivisions of the cash account had been accounted for. The same procedure is applied to all other accounts.

In addition to the foregoing, it is customary to date each schedule with the date of the audit and to append the initials of the accountant preparing the schedule together with the date at which the work is performed. Adjusting journal entries should also be prepared both for inclusion in the work sheet and submission in the report so that the bookkeeper can correct his books and bring them into agreement with the audited accounts.

13. HOPKINS DEPARTMENT STORE—PART II

CASH COUNT: HOW COULD YOU GO ABOUT COUNTING THE CASH AND PREPARING SCHEDULES FOR THE SAME?

A cash count at the close of business on December 31, 1927 was the first step taken in the annual audit of the Hopkins Department Store.

A large strong box contained the customers' remittances for the day and another smaller one contained the petty cash fund. These were brought to the tube room in order that the contents could be examined at the same time the cash for change and from sales was being counted.

The petty cash box contained the following cash items:

4—$5 Bills	1—$.10 Piece
2— 2 "	1— .05 "
11— 1 "	5— .01 Pieces
8— 2.50 Gold Pieces	

Vouchers for expense payments totaling $69.80, and a memorandum for $25 signed by A. Hanley, shipping clerk, were found. All expense vouchers appeared to be bona fide and proper.

The box for customers' remittances was found to contain $756.49 in checks and $79.50 in cash. The count was in agreement with the records which showed remittances for the day totaling $835.99.

The cash for change and from sales amounted to $2,418.43. Of this, $310.11 was segregated in one paper envelope for deposit along with the customers' remittances in the National City Bank; $1,208.32 was in another envelope for deposit in the New Rochelle Commerce and Trust Company. While it was customary for the night clerk to make up these deposits, this had been done on the afternoon of December 31 in order to close the books for the year. The deposit slips were attached to the envelopes and the cashier had entered the amounts as deposited in the banks—$1,146.10 in the National City Bank and $1,208.32 in the New Rochelle Commerce and Trust Company.

Cash in the shipping room was next counted. It consisted of $11.43 in cash and $13.57 in vouchers. The shipping clerk kept two other boxes; one containing stamps amounting to $41, which had been charged to expense when the stamps were purchased, the

other containing $1.41 in small coins, which had been received from customers for special wrapping of packages.

In addition to the foregoing items, the manager held the following uncalled-for pay envelopes in his office:

K. M. Harris, week of August 26, 1927	$8.40
L. P. Mears, week of September 10, 1927	2.50

and 96 cents for the Midway Employment Service which was commission due for help furnished and would probably be called for sometime. The manager was of the opinion that Harris and Mears would not call for the money due them. There were no notes receivable or securities among the assets.

The manager signed the following request for a bank certificate:

December 31, 1927

National City Bank,
New Rochelle, New York

Gentlemen:

Our auditor, Mr................desires a certificate as to the amount on deposit with you at the close of business on December 31, 1927, and we shall be obliged if you will fill in the attached form and mail it to him direct.

Also, please furnish Mr..............with full particulars of any loans or advances you may have made to us that were unpaid on the above date, and also any items upon which we were contingently liable.

Yours very truly,

HOPKINS DEPARTMENT STORE,
.....................Manager

In compliance with this request, the National City Bank returned the following certificate:

Mr......................
....
....

Dear Sir:

We hereby certify that the balance(s) on our books to the credit of the Hopkins Department Store at the close of business December 31, 1927, was/were:

Commercial account..........$36,518.49....................
Savings account...
....
....
Loans and advances were..............none................
....
....
Contingent liabilities were:.............none................
....
....

Yours very truly,

January 3, 1928 ....

{*Cashier*
{*Treasurer*

The manager signed three more such requests, one addressed to the Horton National Bank, another to the New Rochelle Commerce and Trust Company, and a third to the Security State Bank. With each of them an addressed and stamped envelope was enclosed.

What precaution should be taken in making the above cash counts?

Describe each step that would be taken in making this audit.

Prepare the various schedules and entries you would need to show the work done.

14. HOPKINS DEPARTMENT STORE—PART III

CASH IN BANK: HOW SHOULD CASH DEPOSITED IN A BANK BE AUDITED?

During the interval between the mailing of the bank certificates and their return, tests of the various cash records were made. These records consisted of the following books:

1. Check Register
2. Cash Receipts
3. Customers' Remittances
4. Cash Sales Book

All disbursements, except those made from petty cash, were made by check and were recorded in the Check Register.

CHECK REGISTER

Check No.	Date	Payee	Credit		Debit			National City		New Rochelle Commerce & Trust Company		Horton Nat. Bank	
			Amount (*a*)	Discount	Sundries	Accounts Payable Mdse.	Accounts Payable Expense	Ck.	Bal.	Ck.	Bal.	Ck.	Bal.

The last three columns of the Check Register were for memoranda. The amounts entered in column *a* were entered in the appropriate bank column also. Deposits were entered in red in the check column under the proper bank columns. The "Balance" column showed the funds available at each bank.

The columnar headings of the Cash Receipts Book are shown below:

CASH RECEIPTS BOOK

Date	Account or Explanation	Debit		Credit													
		New Cash	General Ledger	General Ledger	Accts. Rec.	Men's Clothing	Men's Furnishings	Women's Clothing	Women's Apparel	Children's Apparel	Shoes	Furniture	Stationery	Hardware and Sporting Goods	Piece Goods	Special Order

The credits to Accounts Receivable came from the Customers' Remittances Book. Those for the departments came from the Cash Sales Book.

The amount columns of the Customers' Remittances Book were as follows:

(*a*) Net Cash
(*b*) Accounts Receivable
  1. A-F
  2. G-L
  3. M-P
  4. Q-Z

Payments on account, when paid in person, were made to the cashier, who recorded them at the time in the Customers' Remittances Book. Remittances by mail were handed to the cashier by the office manager who opened all mail. The cashier totaled the Remittances Book daily and recorded the totals in the Cash Receipts Book. The Customers' Remittances Book was then given to the accounts receivable bookkeepers for posting.

The Cash Sales Book was a recapitulation of the sales tickets. This record was prepared at night by the night clerk who, in addition to other duties, was required to account for all sales slips by salespersons. Different style tickets were used for cash and for charge sales. The cash sales slips came from the tube room and were first arranged by departments and then by clerks. Each slip was listed separately on the recapitulation sheet; then department and grand totals were taken. The night clerk counted the funds received from the tube room and, after deducting the change fund, compared the remainder with the grand total of the cash sales slips. Differences were recorded in a memorandum Over and Short Book which was examined daily by the general manager. Each morning the cashier transcribed the summary of the Cash Sales Book into the Cash Receipts Record.

Tests applied to these records were as outlined below.

For the month of August all checks drawn and returned by the bank, with subsequent statements, were examined, particular attention being given to the payee, amount, signature, endorsement, and bank. As each check was examined it was stamped with a mark to indicate that it had been audited. All checks were found to be correct.

The "Amount of Check" column for the month of August was footed in the Check Register and the totals for all months were cross-footed, no errors being found. All postings to the General Ledger were checked. All items in the general ledger column were checked against vouchers, and all amounts in the accounts payable columns were traced back to the Merchandise and Expense Registers. All disbursements over $500 for other months were examined and found to be properly made and fully authorized.

The Cash Sales Book and the Customers' Remittances Book were footed and cross-footed for five days in August which were chosen at random. All entries in the Cash Receipts Book were checked for August, and were footed and cross-footed for all months, and all posting from the Cash Receipts Book to the General Ledger were checked. Distributions for August which were not checked in detail were scanned and found to be in order.

The daily receipts for August were traced to the bank statements and were found to be in agreement with the following exceptions.

The receipts of August 26 did not agree with the amounts deposited August 27, and the receipts of August 27 did not agree with the deposits of August 29. Subsequent deposits were not in agreement with the daily receipts as shown by the following schedule, on page 241.

The receipts of October 11 and subsequent dates through December 31 were found to be in agreement with their corresponding deposits. A statement to show the discrepancies above listed was prepared and its content discussed with the general manager. The office manager, who was questioned by the general manager, explained that the regular cashier had gone on a vacation the latter part of August and that the acting cashier had become confused because he was not entirely familiar with the system. After the return of the regular cashier it was some time before the discrepancies were eliminated. The cashier stated that he would take steps to prevent the recurrence of such a situation.

The previous audit working papers contained bank reconciliations. A search was made through the several lots of checks returned by the banks since the prior audit for checks dated December 31, 1926, and before. These checks were marked off against the lists of checks outstanding as of December 31, 1926;

all were accounted for. In checking off these checks it was observed that the perforation cancellations were dated subsequent to December 31, 1926.

Daily Receipts and Deposits

Date 1927	Receipts	Deposits	
		National City Bank	New Rochelle Commerce & Trust Company
August 26	$ 4,981.00	$ 2,977.40	$ 1,842.65
" 27	6,545.75	3,500.00	1,614.70
" 29	5,619.32	3,781.10	2,929.65
" 30	7,787.18	1,660.00	4,594.32
" 31	6,790.59	2,941.16	5,046.02
September 1	5,516.79	4,280.54	812.72
" 2	4,847.08	3,128.37	3,355.73
" 3	3,958.63	2,010.59	375.58
" 6	7,219.15	594.75	2,661.83
" 7	5,439.35	3,981.08	6,131.03
" 8	6,000.03	2,236.93	3,202.42
" 9	5,350.15	2,817.45	3,182.58
" 10	4,751.46	2,960.15	2,390.00
" 12	3,962.18	2,371.64	2,379.82
" 13	2,930.30	2,067.23	3,141.10
" 14	3,317.68	30,990.90	3,000.00
" 15	44,672.37	824.98	10,009.10
" 16	4,016.40	....	512.00
" 17	4,193.76	3,645.19	4,574.73
" 19	3,818.29	3,100.00	1,093.76
" 20	4,122.73	1,692.83	2,125.46
" 21	3,918.65	4,278.07	3,763.31
" 22	5,001.64	....	....
" 23	5,716.63	....	....
" 24	4,860.55	3,982.54	6,735.73
" 26	5,116.47	2,549.92	2,421.74
" 27	4,747.19	....	....
" 28	3,185.16	1,960.50	3,039.82
" 29	4,523.46	4,073.86	4,531.12
" 30	4,747.97	1,829.10	2,694.36
October 1	4,762.86	2,371.12	2,376.85
" 3	5,329.50	2,815.15	1,947.71
" 4	5,294.18	2,163.37	2,498.54
" 5	5,580.45	2,391.64	2,902.54
" 6	6,037.53	3,144.00	2,436.45
" 7	5,640.22	3,213.76	2,823.77
" 8	6,391.81	2,460.25	3,179.97
" 10	6,160.42	2,982.55	3,409.26
" 11	6,483.96	3,241.26	2,919.18

The company's bank reconciliation for the National City Bank, prepared by the cashier, as of November 30, 1927, was as follows:

Balance, November 30, per bank statement		$38,472.19
Less checks outstanding:		
#33,729	$ 70.86	
#33,805	4.29	
#34,561	15.87	
#34,584	30.28	
#35,940–35,981	1,640.14	
#35,982–36,125	2,269.80	4,031.24
Balance, November 30, per cash book		$34,440.95

The company's Cash Book showed the following amounts on deposit as of December 31, 1927:

National City Bank	$30,444.10
New Rochelle Commerce and Trust Company	31,192.64
Horton National Bank	520.40

It was noted that the customers' remittances and cash from sales counted December 31 were deposited January 2; $1,146.10 in the National City Bank and $1,208.32 in the New Rochelle Commerce and Trust Company. The certificate received from the National City Bank stated that as of the close of business December 31, 1927, the credit to the Hopkins Department Store on its books was $36,518.49. This was in agreement with the bank statement on which appeared a credit for interest on December 31 of $69.42.

Among the checks returned with the December bank statement from the National City Bank were the following: #33,729; #34,584; #35,940–#35,981; #35,982–#36,125; #36,126–#36,144; #36,146–#36,270; #36,272–#36,283; #36,287–#36,295.

Check disbursements during December from the National City Bank were reported in the Check Register to be the following:

Check Nos.	Amounts
36,126–36,144	$ 6,522.14
36,145	107.28
36,146–36,270	50,162.93
36,271	54.19
36,272–36,283	2,370.00
36,284	13.13
36,285	29.64
36,286	250.00
36,287–36,295	3,963.71
36,296–36,310	2,549.84
36,311–36,336	4,126.83
	$70,149.69

The certificates received from the New Rochelle Commerce and Trust Company and from the Horton National Bank were in agreement with the December statements from these banks. The statement from the New Rochelle Commerce and Trust Company showed a balance of $30,056.59 including interest amounting to $72.27; that from the Horton National Bank showed a balance of $521.27 including interest amounting to $0.87. The interest credits had not been taken up on the books.

A test of the transactions at each bank substantiated the balances reported.

In addition to the above accounts, a special cash deposit was maintained at the Security State Bank on which the pay roll checks for the officers and directors were drawn. The bank's certificate stated that on December 31, 1927, there was a balance of $1,875.00 in this account which was designated "Advanced Salaries." Checks which had been drawn on this account in 1927 but were not cashed until 1928 were as follows:

Check No.	Date	Amount
180	12/31/27	$ 200.00
181	12/31/27	75.00
182	12/31/27	100.00
183	12/31/27	300.00
184	12/31/27	1,000.00

Prepare suitable schedules and enter necessary adjustments on the working trial balance. Should any further verification be made? Discuss critically the work done.

CHAPTER V

AUDIT OF SECURITIES

15. RANDALL MANUFACTURING CORPORATION

SECURITIES: HOW CAN AN AUDITOR ASCERTAIN WHETHER THE SECURITIES OWNED BY HIS CLIENT HAVE BEEN PLEDGED?

The accounts of the Randall Manufacturing Corporation were audited during the month of September, 1920, as of June 30, 1920. The company owned $200,000 of securities as of June 30 and throughout the month of September. The books showed that as of June 30 the company was indebted on notes payable to one of the local banks to the extent of $150,000. The auditor wrote a letter to the bank as follows:

> We are engaged in making a regular examination of the accounts of the Randall Manufacturing Corporation as of June 30, 1920, and desire to verify the amount of notes payable on which the company was indebted on that date.
>
> Will you please write to us stating the principal amount, maturity date and rate of interest on each note bearing the name of Randall Manufacturing Corporation as obligor or endorser which you held as of June 30, 1920.
>
> A stamped addressed envelope is enclosed for your convenience in reply.
>
> Very truly yours,
> ADAMS & COMPANY, *Auditors.*
>
> Please comply with the above request.
>
> RANDALL MANUFACTURING CORPORATION.
> *By* L. F. LATHROP, *Treasurer.*

The bank wrote a letter to Adams & Company giving a list of notes totaling $150,000.

Unknown to the auditor, the treasurer of the company went to the bank on the day when the auditor began his examination and told the note teller that the company had decided to pay off the loan. Mr. Lathrop gave the bank a check from the corporation for $150,000 and received back $175,000 of securities which the

bank had been holding as collateral on the notes. The treasurer deposited the $175,000 in securities in the safe at the company's office. On the day following, the auditor inspected securities which the treasurer produced and found all the securities that were represented in the ledger at $200,000. Soon after the auditor had counted the securities, the treasurer went back to the bank and said he had made a mistake in paying off the notes; that the company would need the money and that he would like to give a new note or notes for $150,000 with the same collateral. The bank agreed to the proposal and took back the securities. The facts in this paragraph were revealed after the company became insolvent in 1921.

The balance sheet as of June 30, 1920, which was certified by the auditor showed the securities to be owned and unpledged.

Should the auditor have detected Mr. Lathrop's procedure? What are the responsibilities of an auditor in a case like this?

16. LYDWELL COLLEGE FUND—No. 2

ENDOWMENT FUND: WHAT VERIFICATION OF INVESTMENTS IN AN ENDOWMENT FUND IS NECESSARY IN AN AUDIT?

In 1920 Mr. Lydwell started an endowment fund for the purpose of aiding a few of the graduates of the Blackwell High School in paying their way through college. Since then other citizens had added to the fund which was managed by a board of trustees. The executive responsibility, however, was in the hands of the treasurer, who kept the books, took care of the investments, paid the expenses, and collected the income. Occasionally his accounts were audited and early in 1928 the board decided that another audit should be made as of December 31, 1927.

As a part of the audit procedure, the accountants desired to examine the investments included in the endowment fund. They found that the treasurer could sign checks alone, but that he could not open the safe-deposit box containing the securities, except in the presence of another trustee. Consequently, the auditors tried to make arrangements to meet two of the trustees at the bank on the same morning that they verified the cash balances.

Unfortunately this arrangement could not be carried out. The cash balances were verified on February 27, 1928, and on March 22, the securities were counted at the bank.

Two years before, at the time of the previous audit, a detailed list of the securities held December 31, 1925, had been prepared. On the basis of this list and the details of the transactions since, the auditors prepared a list of securities that should be in the safe-deposit box at the time of count.

The more important information contained in this list is given in the following exhibit:

LIST OF INVESTMENTS WHICH SHOULD BE IN BOX AT TIME OF COUNT

Name of Issue	Rate	Maturity Date	Par	Cost	Market Value About December 31, 1927
Akron, Canton & Youngstown R. R....	6s	1930	$ 600	$ 606.00	$ 615.75
Akron, Canton & Youngstown R. R....	5½s	1945	1,500	1,410.00	1,490.63
American Tel. & Tel. Co............	5s	1946	2,500	2,479.17	2,525.00
Columbus Power Company..........	5s	1936	1,000	792.50	950.00
Columbus Electric & Power Company.	6s	1947	1,500	1,575.00	1,582.50
Chicago, Burlington & Quincy R. R...	5s	1971	2,000	1,940.00	2,170.00
Consumers Power..................	5s	1936	1,000	896.25	1,042.50
Duquesne Light....................	6s	1949	1,000	860.00	1,050.00*
American Agricultural Chemical Co...	7½s	1941	500	487.50	523.75
Eastern Massachusetts Street Railway	4½s	1948	2,000 }	1,760.00	{ 1,460.00
Eastern Massachusetts Street Railway	6s	1948	100 }		{ 91.25
Great Lakes Power Company, Ltd....	6s	1931	1,000	1,000.00	1,020.00
Illinois Central & Chicago, St. Louis & New Orleans..................	5s	1963	2,000	1,890.00	2,135.00
Milwaukee Electric Railway & Light..	4½s	1931	1,000	970.00	1,003.75
Portland Railway Light & Power.....	5s	1942	1,000	962.50	977.50
Seattle Electric Company...........	5s	1939	2,000	2,000.00	2,030.00
U. S. Rubber Company.............	5s	1947	500	463.42	478.75
West Penn Power..................	5s	1963	500	441.25	530.00
			$21,700	$20,533.59	$21,676.38

* Called July 1, 1927, at 105.

MORTGAGES

Property	Date Purchased	Rate	Amount
37 Blaine Street Blackwell......................	June 7, 1927	6 %	$3,300
142 Exeter Street North Bluffs..................	February 18, 1928	6 %	4,000

In the case of the bonds, the name of the issue, the coupon rate, the number on the bond, the maturity date, the interest dates and the par value were all verified. The coupons were examined to see that all those due had been clipped and that all the rest were still attached. Two of the bonds, the Duquesne Light and the American Agricultural Chemical, were not in the box. Instead,

there was a memorandum made out on a regular bank form which stated that these bonds had been called on July 1, 1927, and February 1, 1928, respectively, and had been turned over to the bank on those dates for collection. The auditors accepted this verification as sufficient.

Both of the mortgages had been purchased from the Blackwell Trust Company on the dates shown in the list above. In the case of the Blaine Street property the mortgage note endorsed over to the trustees for the Lydwell College Fund and the mortgage were found by the auditors and examined for rate, amount, location of the property, and due date. A fire insurance policy for $3,500 covering this property was found to be still in force. There was only a note as to the other mortgage, signed by the treasurer for the trustees. It stated that the mortgage note had been left in the hands of the Blackwell Trust Company, which was to collect the interest. The details of this transaction were verified by correspondence with the bank. The title of the Blaine Street Property was looked up to be sure that it had been assigned to the trustees for the Lydwell College Fund. One of the junior accountants maintained that it was not necessary to look up the title to the other mortgage, as it had been bought since the end of the audit period, December 31, 1927. The senior insisted that the conveyance be verified by looking it up in the records of the Registry of Deeds. It was found that the transfer had been properly recorded.

The following table gives a list of the changes in the security holdings from the date of the previous audit up to the date of counting the securities. The call prices of the bonds were verified by communication with an investment house and the cash received was traced into the bank. No broker's advice could be found for the purchase of Akron, Canton & Youngstown bonds. The auditors, therefore, verified the approximate cost price from the *Commercial and Financial Chronicle.* The Standard Diary stock was sold to a private party so that there was no evidence of the sales price save the deposit of the cash. Quotations were difficult to obtain as the stock was unlisted, but the treasurer offered to obtain a letter from the individual to whom he sold it. The auditors felt, however, that this would be of little value in verification because anybody could sign the certificate and the auditor would not know the difference.

CHANGES IN SECURITIES DECEMBER 31, 1925—MARCH 22, 1928

Date of Transaction	Name	Call Date	Par	Cost	Sales Price
Called or Sold					
Mar. 3, 1926	Utica Gas & Electric	Mar. 1, 1926	$1,500	$1,485.00	$1,567.50
June 2, 1927	Standard Diary Stock	- -	2,200	-	2,530.00
Oct. 4, 1927	Adirondack Power & Light	Sept. 1, 1927	1,000	845.00	1,065.00
Oct. 4, 1927	Goodyear Tire & Rubber Co.	Nov. 1, 1927	1,000	1,165.00	1,200.00
Jan. 31, 1928	Adirondack Electric Power	Jan. 1, 1928	1,000	1,000.00	1,050.00
Feb. 2, 1928	Alabama Power	Dec. 1, 1927	1,000	1,000.00	1,050.00
Mar. 22, 1928	American Agricultural Chemical	Feb. 1, 1928	500	487.50	517.50
Mar. 22, 1928	Duquesne Light	July 1, 1927	1,000	860.00	1,050.00
Purchased					
May 11, 1927	Akron, Canton & Youngstown R. R.	-	1,500	1,410.00	

Did the auditors make a sufficient verification of the endowment fund investments?

Did they do more than was necessary?

At what figure should the investments have appeared on the balance sheet for December 31, 1927?

17. PHILIP C. BROWN

INVESTMENT ACCOUNTS: WHAT STEPS SHOULD BE TAKEN IN VERIFYING PERSONAL INVESTMENT ACCOUNTS?

You are authorized to audit the personal accounts of Mr. Philip C. Brown. A transcript of his ledger accounts representing investments and copies of memoranda of sales of bonds is given on pages 249–252.

LEDGER ACCOUNTS

COMMONWEALTH OF AUSTRALIA, 5S, 1955
Interest Jan. 15 and July 15

Date	Item	Ref.	Debit	Date	Item	Ref.	Credit
1926 Mar. 6	1M	C4	$995.00	1927 July 5			$973.97

PROVINCE OF BUENOS AIRES, 7S, 1957
Interest June 1 and Dec. 1

Date	Item	Ref.	Debit	Date	Item	Ref.	Credit
1926 Dec. 22	1M	C102	$947.50	1927 July 1			$936.14

KINGDOM OF BELGIUM, 7S, 1955
Interest June 1 and Dec. 1

Date	Item	Ref.	Debit	Date	Item	Ref.	Credit
1925 Sept. 10	3M	C70	$2,940.00	1927 July 1			$3,213.39

KINGDOM OF BELGIUM, 8S, 1941
Interest Feb. 1 and Aug. 1

Date	Item	Ref.	Debit	Date	Item	Ref.	Credit
1926 June 10	1M	C55	$1,000.00				

AMERICAN TELEPHONE & TELEGRAPH CO.

Date	Item	Ref.	Debit	Date	Item	Ref.	Credit
1925 Jan. 16	24 shares		$3,192.00	1926 June 11	12 rights		$72.00
1926 July 20	2 shares		200.00	1927 July 20	16 shares		$2,654.75

GENERAL MOTORS CORPORATION

Date	Item	Ref.	Debit	Date	Item	Ref.	Credit
1926 July 2	10 shares		$1,490.00	1927 Feb. 4	9 shares		$1,404.60
1926 Sept. 12	5 shares		Stock Div.				

For account of INVESTORS BANKING CORPORATION
25 Broadway
New York City

Our Number
8819

Date
JULY 1, 1927.

Confirmation of Purchase from

MR. PHILLIP C. BROWN
61 Woodlawn Avenue
Rochester, New York

Amount Cpn. or Reg.	Security	Rate	Month-Mat.-Year
1,000	COMMONWEALTH OF AUSTRALIA	5s	7/15/55

Price	Flat or & Int.	
97 3/4	LESS 2.00 LESS 25.00	WITHOUT JULY 15 COUPON

Principal	Days Int. or Dividend	Interest or Div. Accrued	Total Due
975.50	169	23 47	998 97
		July cpn. -	25
			973 97

FIGURED FOR PAYMENT JULY 4th

In accordance with your instructions, we have sold for your account the above-mentioned securities.
Disposition of the proceeds will be made as indicated.

Yours very truly,

INVESTORS BANKING CORPORATION

By J. M. JORDAN

ATKINS BROTHERS AND COMPANY No. 8748
100 Nassau Street
New York City

For Delivery JUNE 30, 1927

MR. PHILIP C. BROWN

SOLD for your account and risk according to the rules of the Boston & New York Stock Exchanges.

Broker		Description	Price	Amount	Stamp Tax	Comm's	Net Amount
WTK	IM	BUENOS AIRES 7S 1957	93¼	932 50			
			INT JD	5 64			
				938 14		2.00	936.14

It is agreed between you and ourselves:

1. That transactions executed on the Boston Stock Exchange, the New York Stock Exchange or other Exchange shall be subject to the rules and E.&O. E. customs of the Exchange where executed, and of its Clearing House.

2. That securities from time to time carried for your account or deposited to protect your account, may, without further notice to you, be loaned by us or be pledged by us, either for the sum due thereon or for a greater sum, and either separately or together with other securities.

3. That you are to keep a margin satisfactory to us, and that whenever we deem necessary for our protection, we shall have the right in our discretion to close your account either at public or private sale or both, and without further notice to you or any demand for more margin.

WATSON, TIRRELL & CO. Investment Bankers 50 Pine Street		Sold for Mr. Philip C. Brown 61 Woodlawn Avenue Rochester, New York.	
New York City	June 30, 1927.		
*$2,000 Kingdom of Belgium External 7's Due June 1, 1955,			
at 104¼		$2,085.00	
Less com.		4.00	
		$2,081.00	
Int. from June 1 0/29		11.28	$2,092.28
*1,000 Kingdom of Belgium External 8's Due February 1, 1941,			
at 109		$1,090.00	
Less com.		2.00	
		$1,088.00	
Int. from February 1 4/29		33.11	$1,121.11
		Amount due you, Check herewith	$3,213.39

* These transactions were executed on the New York Stock Exchange by Kraus and Company who charged us $6.00 Commission.

Audit the ledger accounts accepting as correct all the debit entries and assuming that the credit entries in the stock accounts represent the cash proceeds from sales.

18. THE MOREHOUSE FOUNDATION

CASH ACCOUNTS: HOW SHOULD FUNDS BE SHOWN ON THE BALANCE SHEET?

Wade and Benton, certified public accountants, were engaged to audit the books of account of The Morehouse Foundation for the year 1937. The practice of the Foundation had been to merge the investments of its restricted and its unrestricted funds. By restricted funds were meant those upon which there were restrictions on the use of principal. The terms of gift or bequest did not require that any of the funds be separately invested. Profits and losses on the sale of security investments were carried in a ledger account entitled Unappropriated Profit or Loss on Sales of Securities.

The principal amount of the restricted and unrestricted funds had increased with each year prior to 1937. The rate of increase in each class of funds during this period had been approximately uniform, the principal amount of the restricted funds having been at all times approximately twice that of the unrestricted funds.

During the year 1937, The Morehouse Foundation expended $100,000 for unusual repairs to certain buildings which it owned. Funds for this purpose were provided through the sale on October 9, 1937, of securities which cost $150,000. This loss of $50,000 had been charged to the Unappropriated Profit or Loss on Sale of Securities account and the expenditure of $100,000 had been charged against the General (unrestricted) Funds account.

The funds and their assets at October 8 and 9 were as follows:

	October 8, 1937	October 9, 1937
Debit Balances:		
Cash	$ 15,000	$ 15,000
Securities (cost)	650,000	500,000
	$665,000	$515,000
Credit Balances:		
Restricted Funds	$400,000	$400,000
General Funds (unrestricted)	200,000	100,000
Unappropriated Profit or Loss on Sale of Securities	65,000	15,000
	$665,000	$515,000

The value of all securities owned as of October 8, 1937, at market quotations was $550,000. No change in funds or fund assets occurred between October 9, 1937, and December 31, 1937, at which date the value of the securities owned, at market quotations, was $475,000.

Indicate how you, as a member of the firm of Wade and Benton, would set forth the funds and fund assets on a certified balance sheet as of December 31, 1937, giving your reasons and weighing alternatives.

CHAPTER VI

AUDIT OF ACCOUNTS AND NOTES RECEIVABLE

19. POPE MACHINE COMPANY

ACCOUNTS RECEIVABLE: HOW SHOULD ACCOUNTS RECEIVABLE BE AUDITED?

A transcript of a ledger account with a customer, J. C. Berwick Company, in the accounts receivable ledger of the Pope Machine Company is given below:

J. C. BERWICK COMPANY

Terms 2%, 10 days, net 30
F.O.B. Shipping Point—Freight Allowed

Date 1926	Explanation	For	Amount	Date 1926	Explanation	For	Amount
July 14	Inv. 1068	S120	$ 4,160.24	July 22	Cash	C118	$ 4,062.04
28	" 1092	S126	299.18	22	Disc. & $15.00	C118	98.20
Aug. 1	" 1098	S126	250.00	Aug. 9	Cash	C136	544.18
2	" 1104	S130	2,080.00	9	Disc.	C136	5.00
10	" 1110	S136	3,050.00	21	Cash	C143	1,754.10
12	" 1115	S138	1,800.10	21	Disc. & $10.00	C143	46.00
23	" 1126	S143	1,200.00	24	Cash	C145	2,989.00
Sept. 8	" 1158	S160	233.35	24	Disc.	C145	61.00
26	" 1190	S163	1,850.00	Sept. 1	Cash	C149	1,171.00
Oct. 5	" 1215	S168	1,000.00	12	Claim 42-Inv. 1158	J32	26.50
6	" 1218	S169	254.00	18	Cash	C158	199.68
8	" 1227	S171	2,080.00	18	Disc. & $2.50	C158	7.17
Nov. 15	" 1314	S212	500.00	Oct. 8	Cash	C190	1,808.00
Dec. 22	" 1468	S268	1,000.00	8	Disc. & $5.00	C190	42.00
				14	Returned goods—Inv. 1227	J46	120.00
			$19,756.87				
				15	Cash	C197	1,224.92
				15	Disc. & $4.00	C197	29.08
				20	Cash	C203	1,908.40
				20	Disc. & $10.00	C203	51.60
							$16,147.87

Your assistant has discovered and has reported to you that a freight deduction of $5.00 was allowed in the settlement of Invoice No. 1126. The only voucher which your assistant has been able to find for returns and allowances credited to the account was the following:

POPE MACHINE COMPANY

Claim No. 42

CLAIM DEPARTMENT

Claimant: J. C. Berwick Co.—Invoice 1158

Date: Sept. 12, 1926

Quantity	Article	Stock No.	Price	Amount
10	Special Machine Parts	614	$2.65	$26.50
	Total			$26.50

Reason: Parts not in accordance with specifications.

Stock Received:

W. S. Mills
Storekeeper

Approved for Credit

E. B. Anderson
Claim Agent

Approved:

R. B. White
Account

Audit the above account.

20. EVESHAM MANUFACTURING COMPANY

ACCOUNTS RECEIVABLE: WHAT QUESTIONS ARISE IN THE AUDIT OF MISCELLANEOUS RECEIVABLES?

A public accountant, while auditing the books of this company, found that the trial balance as of December 31, 1930, showed:

Accounts Receivable	$1,369,926
Notes Receivable	52,890

Analysis of the accounts receivable ledger revealed:

Total of 41 accounts having credit balances	$29,730.03
Total of 502 accounts having debit balances	1,399,656.03

The credit balances represented overpayments and allowances for goods returned.

Examination of the items included in Accounts Receivable disclosed the following:

Amount	Employee	Date of Borrowing	Information Obtained by Auditor
$ 840	R. F. Townes	9/13/30	Payment was promised by May 1, 1931.
352	A. L. Winsor	10/22/30	He was paying $20 per week which was being deducted from his wages.
650	R. O. Waters	5/ 1/28	He was discharged August 21, 1930 when he was discovered short $650 in his accounts. He subsequently disappeared.
133	George Mason	12/15/30	He promised to pay February 1, 1931.
1,100	J. M. Fitts	11/30/30	Fitts was plant superintendent. He was paying $100 a month.
150	A. A. Benton	4/ 3/29	He left employ November 30, 1930 and was out of work. He promised to pay when he could.
600	M. E. Masters	12/20/30	Masters was a plant foreman. He promised to pay by February 1, 1931.
$3,825			

1. Amounts due from employees and former employees as per schedule shown above.

2. An account of $26,000 for advances to G. B. Paine, the president of the Evesham Company. Paine's contract specified that he was to receive a percentage of the company's profits in addition to his salary. Paine authorized the crediting of this bonus (as earned) against the amount he owed the company. The bonus in the past had amounted to about $12,000 a year.

3. Advances to agents............................ $8,730
This amount had been advanced to salesmen and agents as working funds.
4. Consignment accounts.......................... $23,400
These represented goods shipped on consignment to the Reese Company and in the latter company's warehouse on December 31, 1930.
5. Due from the George L. Jarrett Company......... $50,000
This represented goods sold during December, 1930 to the Jarrett Company. Although the Evesham Company owned 81% of the common stock of the Jarrett Company, sales were made to the latter on the same terms as to other trade customers.
6. Due from the Bay Point Manufacturing Company.. $120,000
This amount was advanced to the Bay Point Company (in which the Evesham Company owned 96% of the stock) during November and December of 1930. $80,000 of the amount advanced was used for the purchase of new machinery; $40,000, for the purchase of raw materials.
7. Due from the Cascade Insurance Company........ $21,600
Goods insured with the Cascade Insurance Company were destroyed during a fire at one of the company's warehouses. The insurance company had agreed to settle for this amount.

Examination of the items included in Notes Receivable disclosed:

1. Due on stock subscriptions...................... $30,000
Final payments were due December 10, 1931.
2. A note dated September 1, 1930, due December 1, 1930, signed by A. J. Pitts, and bearing interest at 6%.. $3,000
The note was given on September 1 in settlement of an account resulting from a purchase on June 13, 1930, and was endorsed by H. E. Pitts. As of September 1 an entry was made debiting Notes Receivable and crediting Accounts Receivable. When the note matured on December 1 no notice of protest was sent. No entry had been made for interest.

From his investigation the auditor believed the allowance for bad debts, amounting to $58,603, was sufficient to cover losses on the ordinary customers' accounts and on notes receivable.

Outline your procedure in auditing the items mentioned above. Give any journal entries necessary to correct the books.

Show the items as they should have appeared on the balance sheet of the Evesham Company. Assume that separate balance sheets were to be prepared for the subsidiary companies.

21. BARNETT MANUFACTURING COMPANY

ALLOWANCE FOR DOUBTFUL ACCOUNTS: WHAT CONSTITUTES AN EQUITABLE CHARGE AGAINST EARNINGS FOR LOSS ON BAD DEBTS?

Stone & Company, a firm of public accountants, was engaged to make a balance sheet audit of the Barnett Manufacturing Company for the year ended December 31, 1933. The controlling account for accounts receivable as of that date showed a balance of $351,620.85 while the reserve for loss on bad debts showed a balance of $18,000.

In their analysis of bad debt losses the auditors prepared the following schedules.

SCHEDULE I
ALLOWANCE FOR DOUBTFUL ACCOUNTS AND DISCOUNTS
BARNETT MANUFACTURING COMPANY BOSTON, MASSACHUSETTS
DECEMBER 31, 1933

Page No.	Name	Date of Due Balance	Total Account	Amount Considered Doubtful	
1	Adamson, I. L.	2/13/33	$ 3,132.60	$ 1,566.30	50%
1	Broderick, P. T.	3/4/33	4,581.98	1,145.49	25%
1	Crandall, D. C.	5/5/33	7,459.08	2,237.72	30%
2	Donelly, R. P.	4/1/33	595.54	595.54	100%
2	Foster, A. R.	7/3/33	12,260.16	4,904.06	40%
4	Marlow & Company	12/20/32	7,555.50	536.44	Old Balance
4	Plummer, A. C.	1/18/33	4,039.92	3,635.93	90%
5	Roland Manufacturing Company	2/23/33	2,833.50	227.00	Allowed 1/9/34
5	Smith & Son	3/7/33	4,692.66	469.50	Bad Debt 1/4/34
6	Tanner, A. B.	7/25/33	2,186.66	1,093.33	50%
				$16,411.31	
	Discounts taken to 1/31/34			2,806.74	
				$19,218.05	
	Allowance per books			$18,000.00	

NOTE: After discussion with the Treasurer it was mutually agreed that we should increase the Allowance to $19,200.00.

SCHEDULE 2
ALLOWANCE FOR DOUBTFUL ACCOUNTS
BARNETT MANUFACTURING COMPANY BOSTON, MASSACHUSETTS
FOR THE YEAR ENDED DECEMBER 31, 1933

Balance January 1, 1933				$18,000.00
Additions		*Amount*		
Provision made January 1933		$900.00		
" " February "		"		
" " March "		"		
" " April "		"		
" " May "		"		
" " June "		"		
" " July "		"		
" " August "		"		
" " September "		"		
" " October "		"		
" " November "		"		
" " December "		653.86	$10,553.86	
Deductions	*Date of Due Balance*	*Amount*		
Price Machine Works	1/14/32	$1,755.84		
Samson, R. D.	2/23/32	2,246.79		
Seamans, A. L.	5/6/32	651.36		
Johnson, P. R.	6/6/33	1,849.08		
Grove, F. D.	4/20/31	1,167.20		
Badenock, C. N.	6/7/32	1,806.66		
Mellon, K. D.	10/12/32	487.60		
Nickel Manufacturing Company	1/10/33	589.33	$10,553.86	
Balance per Company, December 31, 1933				$18,000.00
Additional Provision—Adjustment No. 8				1,200.00
				$19,200.00

SCHEDULE 3
BAD DEBTS WRITTEN OFF AND RECOVERED
BARNETT MANUFACTURING COMPANY BOSTON, MASSACHUSETTS
FOR THE YEAR ENDED DECEMBER 31, 1933

Bad Debts Written Off	*Date of Due Balance*	*Amount*	
Price Machine Works	1/14/32	$ 1,755.84	
Samson, R. D.	2/23/32	2,246.79	
Seamans, A. L.	5/6/32	651.36	
Johnson, P. R.	6/6/33	1,849.08	
Grove, F. D.	4/20/31	1,167.20	
Badenock, C. N.	6/7/32	1,806.66	
Mellon, K. D.	10/12/32	487.60	
Nickel Manufacturing Company	1/10/33	589.33	
		$10,553.86	
Additions to Allowance for Doubtful Accounts		1,200.00	$ 11,753.86
Less:			
Bad Debts Recovered	*Date Written Off*	*Amount*	
Lane, P. C.	10/12/31	$ 131.30	
Arnold, A. C.	2/10/32	94.58	
Goodrich, A. N.	4/1/32	116.04	
Wells, B. C.	10/11/32	135.00	
Martin & Company	12/12/32	600.00	1,076.92
			$ 10,676.94

In the auditors' schedule of income and expense for the year the losses on bad debts appeared as follows:

Net Profit from Operations			$208,782.94
Other Income			12,614.78
			$221,397.72
Deductions from Income			
Interest Paid	$55,074.82		
Less: Interest Earned	7,040.88	$48,033.94	
Bad Debts Written Off	$11,753.86		
Less: Bad Debts Recovered	1,076.92	10,676.94	
Other Deductions		60,882.04	119,592.92
Net Profit Before Taxes			$101,804.80
Provision for Federal and State Income Taxes			30,891.84
Net Profit Carried to Surplus			$ 70,912.96

Would you certify the above statement of profit and loss? Why? If not, give your reasons, and suggest possible improvements, using figures as far as possible.

22. TWEEDY AND COMPANY

AUDIT OF RECEIVABLES: HOW LARGE A RESERVE FOR BAD DEBTS SHOULD BE SET UP?

Jones and Bailey, certified public accountants, were engaged to audit the books of Tweedy and Company for the period of 4 years ending December 31, 1937. During the course of their audit, they learned that, in order to meet competition, the company had extended a substantial amount of credit, in various forms, to its numerous customers, most of whom were small retailers. An investigation showed that a number of individual balances as at December 31, 1937, aggregating $85,000, were considered to be doubtful of collection, and it was believed that they should be reserved for in full. Of this amount, $25,000 was applicable to sales made during the calendar year 1937, and $60,000 was applicable to sales of 1934, 1935, and 1936. There were no receivable balances in respect of sales prior to 1934. Among the bad debts charged off against operations during the year 1937, balances amounting to $5,500 had resulted from sales made during the calendar year 1937.

After careful consideration, the auditors concluded that, in view of the company's liberal credit policy, the amount of bad debt losses which would eventually result from 1937 sales would probably be considerably in excess of the amounts already definitely ascertained to be bad at the end of that year. It appeared safe to assume that the remaining bad debt losses resulting from sales made in 1934, 1935, and 1936 would not exceed the amount of $60,000 referred to above.

The auditors were of the opinion that a total reserve for bad debts should be provided as of December 31, 1937, which would be predicated on the assumption that the ultimate losses resulting from 1937 sales would be approximately equivalent to the average losses for the three preceding years. To facilitate the calculation of the amount of the reserve which they deemed to be required, the following tabulation was prepared by the auditors.

	1934	1935	1936	Total
Net sales..................	$4,500,000	$4,700,000	$4,500,000	$13,700,000
Bad debts charged off from January 1, 1934, to December 31, 1937, which resulted from transactions originating in the respective years..	$ 66,500	$ 37,000	$ 42,000	$ 145,500
Portion of specific reserve for doubtful balances as at December 31, 1937, attributable to accounts resulting from sales of respective years....................	10,000	20,000	30,000	60,000
Total..................	$ 76,500	$ 57,000	$ 72,000	$ 205,500

The net sales of Tweedy and Company in 1937 amounted to $4,300,000.

State the amount of reserve for bad debts which should in your opinion be provided on the December 31, 1937, certified balance sheet in respect of all receivables carried on the books as of that date.

Of the total receivables of $700,000 carried on the books as at December 31, 1937, it was estimated that approximately $500,000 would be realized upon within one year, and that $200,000 could not be realized upon during that period. Present the statement of receivables as it would appear upon your certified balance sheet as of December 31, 1937.

23. RELIABLE STORES CORPORATION

AUDIT OF RECEIVABLES: HOW SHOULD INSTALMENT RECEIVABLES BE AUDITED?

Practically the entire volume of the Company's business is comprised of instalment plan, *i.e.*, time payment, sales. The customer's obligation usually takes the form of a promise to pay under a conditional sales contract, but in certain states, due to differences in applicable laws, time payment sales are effected by a contract in the form of a rental agreement or by means of a chattel mortgage or other instrument. It is the established policy of the Company in connection with sales

made on the instalment plan to consider, through its credit department, not only the general financial responsibility of a customer but also the purchasing power of a customer at the particular time the instalment indebtedness is incurred, with a view of restricting the assumption of undue financial obligations by the customer, even though such a policy may result in a smaller volume of sales by the Company.

On instalment sales, the initial payment in cash averages approximately 10% of the amount of the sale and the balance is deferred for payment over a period which for all sales averages approximately one year. The period of the deferred payments for refrigerators, clothes washing machines, and such other sales as in the discretion of the management warrant longer terms, is frequently extended for twenty-four to thirty months, in consequence of which a proportion of the instalment accounts receivable is not realizable within one year; however in accordance with the usual practice in the trade, such accounts are carried as current assets by the Company on its balance sheet. It is the policy of the Company to finance instalment sale contracts entirely with its own resources, including occasional bank credits. Thus, as of December 31, 1936, current assets amounted to 94% of total assets, or $8,935,782, of which instalment accounts receivable aggregated $6,894,784 and were comprised of approximately 128,000 individual accounts, or an average of less than $54.00 per account. The instalment accounts receivable are stated after deducting the reserves set up by the Company for doubtful accounts, discounts, and allowances.[1]

A condensed balance sheet at December 31, 1936, and a condensed profit and loss statement for 1936, with accompanying notes, are given as follows:

[1] Prospectus, April 5, 1937.

RELIABLE STORES CORPORATION
AND SUBSIDIARY COMPANIES, CONSOLIDATED
CONDENSED CONSOLIDATED BALANCE SHEET, DECEMBER 31, 1936

Cash on Hand and Demand Deposits		$ 258,698
Merchandise Inventories at Cost or Market, whichever lower		1,752,402
Miscellaneous Accounts Receivable		29,898
Instalment Accounts Receivable (Note 3)	$7,584,104	
Less—Reserve for Bad and Doubtful Accounts, Discounts and Allowances	689,320	6,894,784
Total Current Assets		$8,935,782
Fixed Assets, net of Depreciation		413,201
Deferred Charges		59,715
Other Assets		98,464
		$9,507,162
Bank Loans Payable October 1, 1937		$1,000,000
Bank Drafts Payable		60,118
Mortgage Instalment of Subsidiary Companies, payable July 1, 1937		2,500
Accounts Payable (trade)		651,948
Accrued Liabilities		224,432
Total Current Liabilities		$1,938,998
Reserve for Contingencies		594,863
Other Liabilities		83,611
Capital Stock		
7% Cumulative First Preferred of $100 par		1,156,163
Common Stock without Par Value		2,500,000
Capital Surplus		2,497,253
Earned Surplus (subsequent to 12/31/27)		736,274
		$9,507,162

NOTE 3: Instalment Accounts Receivable:
Instalment Accounts Receivable include accounts in respect of instalment sales made prior to current years, on all of which collections have been made during the last six months of 1936. A proportion of the instalment accounts receivable is not realizable within one year; however, in accordance with the usual practice in the trade, such accounts are carried as current assets in the accompanying balance sheet.

RELIABLE STORES CORPORATION
AND SUBSIDIARY COMPANIES, CONSOLIDATED
CONDENSED CONSOLIDATED STATEMENT OF PROFIT AND LOSS
YEAR ENDING DECEMBER 31, 1936

	1936
Gross profit	$4,058,336
Total expenses	$2,586,044
Loss on bad debts and repossessions (Note 3)	334,058
Together	$2,920,102
Balance of profit from operations	$1,138,234
Other income, less other deductions	14,296
Profit before taxes	$1,123,938
Taxes	201,792
	$ 922,146
Minority Interest	15,667
Net Profit	$ 906,479

NOTE 3: Loss on Bad Debts and Repossessions:

It has been the consistent practice of the Corporation and its subsidiary to charge to profit and loss account annually, uncollectible accounts receivable as well as current losses on repossessions, and also to adjust through profit and loss account, the reserves for bad and doubtful accounts receivable and for discounts and allowances to the amount indicated to be required by the year end appraisals. (See notes to Statement IV—Reserves.) Net losses on bad debts and repossessions for the year . . . 1936 were as follows:

	1936
Losses on repossessions, without considering any reserves previously provided on the accounts repossessed	$306,336
Bad debts charged off without considering any reserves previously provided on the accounts charged off	104,719
	$411,055
Less:	
Credits (net) based on appraisal of instalment accounts receivable transferred from reserves created in previous years for bad and doubtful instalment accounts receivable and discounts and allowances	$ 70,489
Bad debts recovered	6,509
	$ 76,998
Net loss on bad debts and repossessions	$334,057

The detail of the reserve for bad and doubtful accounts for 1936 is given below:

	1936
Balance at beginning	$673,315
Additions charged to other accounts	50,493[1]
	$723,808
Charges: Loss on bad debts and repossessions	$ 67,872
Other income	16,473
Other charges	1,254[2]
	2,869[3]
	$ 88,468
Balance at close of period	$635,340

[1] Reserve acquired in connection with the acquisition of a retail furniture business.

[2] Reduction in respect of reserve acquired on instalment accounts receivable purchased which proved uncollectible.

[3] Elimination of instalment accounts receivable fully reserved for.

RELIABLE STORES CORPORATION
AND SUBSIDIARY COMPANIES, CONSOLIDATED
NOTES TO STATEMENT IV—RESERVES

Reserves for bad and doubtful instalment accounts receivable:

At the close of the year . . . 1936, in accordance with the Corporation's practice, the auditor and the general collection manager of the Corporation and its subsidiary visited the various stores and appraised or, in effect, inventoried, the instalment accounts receivable each year on the same basis, namely:

(*a*) All accounts on which no payments had been received since July 1 of the current year were either reserved for in full or were charged off.
(*b*) A reserve was provided for loss on accounts on which no payments had been received since October 1st of the current year to December 31st of that same year.
(*c*) A reserve was provided for loss on accounts on which payments had been received since October 1st but on which the payments were considerably less than the amounts stipulated under the terms of the instalment contracts.
(*d*) A reserve was provided for loss on sales made during the last three months of each year, October, November, and December, and for discounts and allowances based on the Corporation's experience for the previous five years.

The amounts of the reserves for estimated doubtful accounts and the reserves for estimated discounts and allowances determined as above were as follows:

	December 31, 1936	
	Instalment accounts receivable	Reserves
Gross instalment accounts receivable (after deducting accounts charged off as "no good")	$7,586,973	
Reserves for bad and doubtful accounts resulting from appraisal		$364,830
The percentages to net sales (by individual stores) of bad debts and repossession losses for five years ending December 31st . . . were applied to the sales (by individual stores) for the months of October, November and December and showed an estimated reserve required of		229,259
The percentages to net sales (by individual stores) of discounts and allowances for the five years ending December 31st . . . were applied to the instalment accounts receivable balances of individual stores (after deducting the reserves for bad and doubtful accounts) and showed an estimated reserve required of		53,980
Reserves acquired on instalment accounts receivable purchased		44,120
Elimination of instalment accounts receivable fully reserved for	(2,869)	(2,869)
Total instalment accounts receivable and reserves	$7,584,104	$689,320

The net losses on bad debts and repossessions for . . . 1936 were . . . $334,057. (See notes to statement of profit and loss.)

What procedure should be followed in auditing the company's instalment receivables and reserves?

24. MASTER SHOE COMPANY

ACCOUNTS RECEIVABLE: WHAT SHOULD BE THE AUDIT PROCEDURE WHERE ACCOUNTS RECEIVABLE ARE SOLD TO A FINANCE COMPANY?

You were engaged to audit the accounts of the Master Shoe Company as of December 31, 1927, by the principal stockholder, who was also president and active manager. The corporation had borrowed heavily from banks and had obtained further credit by selling some of its accounts receivable to the XYZ Finance Company. Some of the provisions of the agreement with the Finance Company were as follows:

(*a*) XYZ Finance Company will from time to time, during the continuance of this agreement, buy such accounts belonging to the Master Shoe Company as may be acceptable to the Finance Company, and will pay therefor: 100% of the face value thereof, of which 75% shall be paid in cash upon acceptance thereof by the Finance Company and the remaining 25% less charges (on basis set forth below) immediately upon payment of any such accounts to the Finance Company; provided that no payments of any such remainder need be made so long as any accounts purchased hereunder are affected by any breach of contract or violation of warranty hereunder, but such remainder may be held and later applied to the payment of any accounts or indebtedness.

(*b*) The charge for interest shall be 1/30th of 1% per day on the full face value of accounts during the period they remain uncollected. There shall be paid a service charge of $5.00 for every $1,000.00 of accounts purchased.

(*c*) In consideration of the prompt purchase and remittance by the Finance Company for accounts receivable sold to the Finance Company without waiting to make a complete credit investigation thereof, Master Shoe Company hereby warrants:

(1) That Master Shoe Company is solvent and that each account sold is solvent and will remain so until the maturity of the debt sold.

(2) That a prompt payment will be made to the Finance Company for the amount of any allowance or credit on any account sold to the Finance Company or for any deduc-

tion to be made by reason of any rejection, return, failure, or refusal to accept any merchandise.

(3) Every account purchased hereunder will be paid in full at maturity in cash or New York funds.

(4) Each account offered for sale to the Finance Company shall represent a bona fide sale and shall be for a certain undisputed, liquidated claim or demand which is due on the dates set forth and is not contingent on the fulfillment of any condition whatsoever.

You ascertained the following in your examination:

(1) That the total of the accounts receivable according to the books was $135,000.00.

(2) That $15,000.00 was adequate provision for bad debts upon these receivables.

(3) That of the $135,000.00 of accounts receivable $50,000.00 had been sold to XYZ Finance Company under the agreement described above.

(4) That the Master Shoe Company had received $37,500.00 from the Finance Company from the sale of the above accounts receivable.

(5) Interest and service charges due the Finance Company accrued and unpaid to December 31, 1927, amounted to $275.00.

(6) That among the accounts sold to the Finance Company was an account for $5,000.00, which represented a consignment to A. B. Smith of shoes costing $4,000.00 to be sold by Smith on commission. No part of that consignment had been sold by Smith on or before December 31, 1927.

State exactly how you should have expressed in the balance sheet the various assets and liabilities indicated above.

25. HARRIS, WILLIAMS & COMPANY

BROKERAGE ACCOUNTS: WHAT VERIFICATION OF THE CUSTOMERS' ACCOUNTS IN A BROKERAGE FIRM IS NECESSARY?

Harris, Williams & Company, a brokerage firm, engaged Ralph Lee, a specialist in brokerage audits, to audit the accounts of the firm as of December 31, 1934. Mr. Lee began the audit at the close of business December 31 and had by January 2, 1935, counted the cash, examined stocks and bonds on hand, and had

placed in the mail requests for confirmation of securities in transfer, bank loans and collateral therefor, securities borrowed and loaned, securities failed to receive and failed to deliver, and correspondent brokers' accounts. He next proceeded to the verification of customers' accounts, and the following accounts came to his attention.[1]

ALFRED SAMSON

Date	Bought Re-ceived	Sold De-livered	Description	Price	Debit	Credit	Balance
Dec. 3			On Account			$ 1,800.00	Cr. $ 1,800.00
4		75	Air Reduction	111½		8,333.83*	Cr. 10,133.83
7			Prem. Air Reduction		$ 0.75		Cr. 10,133.08
10			On Account			2,000.00	Cr. 12,133.08
11		100	American Telephone & Telegraph Company†	110		10,961.78	Cr. 23,094.86
12	75		Air Reduction	109¾	8,256.75		Cr. 14,838.11
20	8		Chrysler	38⅛	308.37		Cr. 14,529.74
26	50		American Telephone & Telegraph Company	102	5,117.00		Cr. 9,412.74
27			On Account		3,000.00		Cr. 6,412.74
		8	Chrysler (Alfred Samson)				
31	Long	Short	Balance Forward				
		50	American Telephone & Telegraph Company				Cr. 6,412.74

* Commissions on stock transactions on the New York Stock Exchange were as follows:

[1] On September 27, 1934, the Federal Reserve Board made public Regulation T (Series of 1934) which dealt with the extension of credit on securities. Section 3 read as follows:

Margin Requirements.

A General Rule—No creditor shall make any initial extension of credit to any customer for any registered security (other than an exempted security) for the purpose of purchasing or carrying any security, in an amount which causes the total credit extended on such registered security to exceed the maximum loan.

Value of such registered security.

Except as specifically provided elsewhere in this section, the maximum loan value of any registered security (other than an exempted security) shall be whichever is the higher of

(1) 55% of the current market value of the security; or

(2) 100% of the lowest market value of the security computed at the lowest market price therefor during the period of thirty-six calendar months immediately prior to the first day of the current month but not more than 75% of the current market value: Provided, that until July 1, 1936, for the purpose of this regulation the lowest price at which a security has sold on or after July 1, 1933, but prior to the first day of the current month, shall be considered as the lowest market price of such security during the preceding thirty-six calendar months; and provided, that the lowest market price which could be used under the provisions of this regulation during any calendar month may be used during the first seven calendar days of the succeeding calendar month.

In addition to the margin requirements specified by the Federal Reserve Board

Selling under 50 cents							Optional
$ 0.50 and above but under $					1.00	3	cents per share
1.00	"	"	"	"	10.00	7½	" " "
10.00	"	"	"	"	25.00	12½	" " "
25.00	"	"	"	"	50.00	15	" " "
50.00	"	"	"	"	75.00	17½	" " "
75.00	"	"	"	"	100.00	20	" " "
100.00	"	"	"	"	200.00	25	" " "
200.00	"	"	"	"	250.00	30	" " "

Harris, Williams & Company maintained a minimum charge of $3.00 for any transaction. Taxes and fees were as follows:

Stamp Taxes to be Paid by Seller of Securities

Federal—4 cents for each $100 of par value or fraction thereof on stocks selling under $20, and 5 cents on stocks selling at $20 or over. No par stocks treated as of $100 par.

New York State—3 cents per share on stocks selling under $20 and 4 cents per share on those selling at $20 or over.

Federal Short Sales Tax—Seller must pay 4 cents for each $100 of par value (no par = $100) on shares borrowed to complete delivery.

Fees—Seller must pay 1 cent for each $500 of face value or fraction thereof for registration with Securities and Exchange Commission.

† Quarterly dividend of $2.25 per share declared payable January 15, 1935, to stock of record December 15, 1934.

FRED GRANT

Date	Bought Received	Sold Delivered	Description	Price	Debit	Credit	Balance
Dec. 1, 1934	Long	Short	Balance Forward				
	75		Celanese Corp.				
	50		Libby-Owens Ford Glass				
	50		Texas Gulf Sulphur				Dr. $3,852.95
" 17 "			Dividend 50 Texas Gulf Sulphur			$25.00	Dr. 3,827.95
" 31 "			Interest at 6%		$19.85		Dr. 3,847.80

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the New York Stock Exchange required that member firms maintain margins on customers' accounts of at least 33⅓% of net debit balances of $5,000 or over and of at least 50% on debit balances under $5,000.

On short sales the New York Stock Exchange required member firms to maintain margins of $10 per share on all shares selling for less than $50 and margins of $20 on all shares selling above $50.

How should customers' accounts be verified?

How would you determine the adequacy of the balances of the above accounts?[1]

26. HOPKINS DEPARTMENT STORE—PART IV

ACCOUNTS RECEIVABLE: HOW SHOULD ACCOUNTS RECEIVABLE BE VERIFIED?

The general ledger of the Hopkins Department Store contained a control account for Accounts Receivable which showed a debit balance of $113,859.94 on December 31, 1927. This control account was supported by four subsidiary customers' ledgers, each of which was made self-proving by the use of an intermediate control book which was a memorandum record. A separate section of this memorandum record was devoted to each of the detailed ledgers, the total of each group of charges and credits being posted to the appropriate section, thus making the section a control for the particular ledger. The sum of these intermediate controls was to agree with the Accounts Receivable Control Account in the general ledger.

The night clerk who checked the cash sales tickets as explained in Part III also accounted for and arranged all charge sales tickets. These tickets were arranged by departments and entered on a recapitulation sheet, from which each of the departmental totals was later credited to department sales. Totals were obtained for use in checking postings. After this work had been done, the night clerk re-sorted the tickets and arranged them alphabetically

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1 STOCK QUOTATIONS

Stock	Par Value	Low since July 1, 1933	Market Value Dec. 31, 1934
Celanese Corporation	No par	17⅛	34½
Libby-Owens Ford Glass	" "	22½	32⅛
American Telephone & Telegraph Company	$100	100⅛	104½
Chrysler Corporation	5	26¼	41⅞
Air Reduction	No par	80⅛	112½
Texas Gulf Sulphur	" "	22¾	33⅞

by customers' names into four groups corresponding to the four subordinate ledgers. He then prepared an adding machine tape for each of the groups.

In the verification of the Accounts Receivable as of December 31, 1927, only one subordinate ledger was checked in detail. The other three ledgers were checked as to totals and found to agree with the intermediate control book. It was assumed that if one ledger proved to be accurate, the others would also prove to be accurate if they were checked in detail. For this test, ledger number two which contained accounts with customers whose names began with letters between G and L was used. A list of these accounts was compared with the ledger and files, and all items but one of $6.50 were seen. A tape was run off on the adding machine and its total agreed with the tape made previously by the accounts receivable bookkeeper, and with the intermediate control book. The sum of the accounts receivable which were contained in all four ledgers amounted to $113,859.94; this was net after deducting $535.42 credit balances. These credit balances represented amounts paid by customers in excess of the sums they owed.

In the examination of the accounts receivable ledgers it was noted that several January statements contained items dated December 31. Inquiry revealed that transactions for the last day of December had not been entered and posted until the first week in January in order not to delay the mailing of the December statements to customers beyond January 3. The records indicated that all such sales had been from department No. 11, the Special Order Department, and the total amounted to $260.17.

All accounts were scanned and those over three months old were noted and aged. The manager was then consulted, and the probability of collection was discussed with him. The list of accounts, which was questioned is given as follows with the manager's comments.

Date Account was Rendered	Name	Manager's Opinion	Amount	Remarks
June 30	A. B. Adams	Good	$164.90	
Apr. 30	S. A. Albee	Doubtful	93.14	Bonded, Bond seen
Sept. 30	H. S. Bemck	Good	81.36	
Feb. 28	F. M. Bleiler	Bad	110.43	
July 31	M. E. Breen	Doubtful	47.82	
Jan. 31	O. W. Chase	Bad	76.94	Sent to Nat. Creditors 9/11/27
Feb. 28	J. F. Dee	Bad	37.94	
Aug. 31	F. C. Ebben	Good	119.47	Pd. 1/3/28
May 31	L. A. Fisher	Doubtful	241.36	Acct. Stopped 12/10/27
June 30	E. N. Foss	Doubtful	47.25	
Apr. 30	W. G. Gale	Bad	98.46	
Aug. 31	S. A. Griffin	Good	94.32	Paid 1/25/28
Nov. 30/26	L. W. Hatch	Bad	73.45	
Mar. 31	S. E. Iwing	Doubtful	41.92	
May 31	H. A. Jones	Bad	17.85	
July 31	R. C. Kimball	Good	148.22	
Jan. 31	A. A. Lawson	Bad	183.47	10/10/26 sent to Nat. Creditors Assn.
Sept. 30	G. E. Mannon	Doubtful	122.34	
Mar. 31	D. G. Merlin	Doubtful	132.47	
May 31	W. A. Nelson	Good	92.36	Paid 1/27/28
June 30	O. O. Owen	Bad	42.25	
Apr. 30	W. E. Pierce	Doubtful	244.50	Acct. Stopped 12/2/27
Aug. 31	B. W. Pont	Doubtful	78.80	
July 31	J. A. Russel	Good	119.30	
Dec. 31/26	D. C. Satlin	Bad	74.37	
Jan. 30	J. R. Shields	Doubtful	186.44	
Sept. 30	F. B. Sparks	Good	240.50	Paid 1/10/28
June 30	J. W. Stone	Doubtful	130.75	
Jan. 31	G. R. Teed	Bad	76.50	Nat. Credit. Assn. 1/15/28
May 31	S. D. Tucker	Doubtful	122.47	
Aug. 31	G. E. Valli	Doubtful	96.44	
Nov. 30/26	W. P. Wallace	Bad	62.90	Nat. Credit. Assn. 11/19/27
May 30	C. M. York	Doubtful	80.34	
Aug. 30	F. S. Zola	Good	75.90	Paid 1/27/28

A reserve was set up for all accounts considered bad and for one quarter of the total of those considered doubtful. In addition to this list there were doubtful accounts totaling $15,311.32, for which a similar reserve had to be established.

Prepare schedules for the above and carry necessary adjustments to the working trial balance.

What further analysis should have been made, if any?

CHAPTER VII

AUDIT OF INVENTORIES

27. REVERE COPPER AND BRASS, INC.

INVENTORY VERIFICATION: WHAT PROCEDURE SHOULD BE FOLLOWED IN VERIFYING INVENTORY?

In the course of an examination of expert accounting witnesses by the Securities and Exchange Commission, early in 1939, Mr. C. Oliver Wellington, of Scovell, Wellington & Company, read the following description of his firm's method of auditing the inventories of Revere Copper and Brass, Inc.

We have received certificates from officials at the several divisions of the corporation stating that the inventory quantities were determined by actual count, weight, or measurement, and that adequate provision has been made for imperfect or obsolete stocks.

The physical inventory was taken as at December 31, 1938, by employees of the company, who prepared duplicate prenumbered tickets for the various items in the inventory, retaining the duplicate and leaving the original with the item inventoried. After the inventory count was completed, we accompanied certain executives through the plants, picking up the originals of the tickets, and by various tests satisfied ourselves that the quantities as shown by the tickets were correct. We retained control of the tickets picked up and, upon accounting for all numbers and determining that the inventory had been properly taken, we traced individual items or totals to the inventory summaries prepared from the duplicate tickets. We checked the compilation of the inventory tickets and made substantial tests of the inventories at the fabricating division as to metal and product classifications.

In addition to establishing the correctness of the inventories as taken at the plants, we also confirmed with vendors and customers the quantities of materials belonging to the corporation at other locations or materials belonging to others in its possession. We also checked the mathematical accuracy of the calculations and summaries of the inventory sheets and satisfied ourselves that the prices used were at cost (considering the metal contents of the December 31, 1937, inventory as "cost" for 1938), which in the aggregate was below market.[1]

[1] *The Journal of Accountancy*, April, 1939, pp. 208–209.

Do you consider this procedure adequate when considered in connection with recent extensions of auditing procedure?

What possibilities exist for the auditors to be deceived as to the various items in the inventory when they have made an examination of the type outlined above?

28. DAVIS & SNOW COMPANY

VALUATION OF INVENTORIES: WHEN SHOULD INVENTORIES BE VALUED AT MARKET?

The Davis & Snow Company manufactured a complete line of both felt and leather slippers, which it sold to retail shoe dealers and department stores. The entire capital stock, 1,000 shares of $100 par value, was held by the immediate families of the three men who had originally incorporated the business.

For many years the company had had no bank loans, but with a decrease of sales in 1931 and the first half of 1932, and with working capital largely tied up in inventories, it became necessary to borrow $100,000 from two local banks in July, 1932.

Later, as a condition precedent to continuing the loans, the banks requested that a balance sheet as at December 31, 1932, certified by a public accountant, be submitted to them.

A summary of the inventory as at December 31, 1932, which was submitted by the management to the auditor employed showed the following totals:

Supplies and Materials	$ 60,000
Work in Process	190,000
Finished Goods	210,000
	$460,000

The auditor learned the following facts concerning three items in the inventory:

1. The inventory included a large number of completed "D. & S. Special" slippers. The "D. & S. Special" was an inexpensive slipper introduced to meet competition from Czechoslovakia, which had been sending large quantities of low-priced leather slippers into this country during the last two years, and to "fill out the line." The management, in order that the new product be kept up to the com-

pany's merchandise standards, had specified that good materials be used but that expensive labor operations such as fancy stitching be avoided. Nevertheless, the completed cost of these slippers was \$1.85 per pair (including \$0.17 for selling and administrative expenses) while the factory's price to dealers was \$1.25 per pair. The management had included the completed "D. & S. Special" slippers in the inventory at this market price of \$1.25 per pair.

2. Included in work in process was a large quantity of unfinished slippers being made up into the "D. & S. Special" line. The cost of the component materials was \$0.55 per pair and the cost of the slippers after the first operation in the assembly room was \$0.90 per pair. This work in process had been valued at cost because the treasurer contended that it would be inequitable to write down the assembly room process cost to a price equal to the selling price of the slippers less the cost to complete, for the effect would be to value this part of the inventory far below \$0.55, the cost of materials which had a market value of not less than \$0.55 at December 31, 1932. Further, he pointed out, that, while the original intention was to make this raw material into "D. & S. Special" slippers, it was possible, almost up to the point of completion, to transform the slippers in process into slippers selling at a substantial profit by using a high-grade innersole, fancy foxing, and trimming.

3. Included in the finished goods inventory at a valuation of \$42,000 was a large quantity of kid pullman slippers (in kid cases). Two years previously, the company had purchased for \$4.10 per pair the entire stock of a foreign firm making these pullman slippers. In 1931 a substantial volume of sales of this type of slipper had been secured, but 1932 saw a sharp falling off in the demand. The few sales made in 1932 were for \$3.00 per pair. The valuation assigned in the 1932 inventory was \$3.55 per pair, which the treasurer pointed out was the mean between cost and market. He stated that it would be necessary to carry the slippers at market valuation, comparable to what might be realized by forced sale, only if the company were insolvent and needed to liquidate its holdings, but that, since the Davis and Snow Company was continuing in business, the stock, which would not depreciate, could be carried until conditions improved. He felt sure a fair profit could then be realized.

Explain how you would value these three items in setting up the inventory figure for the balance sheet to be certified.

29. VALLEY MILLS, INC.

FINISHED GOODS: HOW SHOULD AN AUDITOR VERIFY THE VALUE OF FINISHED GOODS THE SALABILITY OF WHICH IS PROBLEMATICAL?

The balance sheet of Valley Mills, Inc., on December 31, 1924, showed the following:

Inventories	$1,400,000.00
Other current assets	600,000.00
Notes payable and other current liabilities	1,100,000.00
Capital stock without par value—stated value	50,000.00
Capital or surplus paid in in excess of stated value	900,000.00
Earned surplus	350,000.00

The auditor who was employed to examine the company's accounts as at December 31, 1924, discovered that the inventory included a single item of $475,000.00 representing 100,000 yards of cloth of a particular style of women's wear known in the trade as "Lowelty."

On February 9, 1925, the auditor received the following letter from the president of the company, whose office was in a city at some distance from the mill:

Dear Sirs:

The delay in giving us the annual audit is causing us quite some inconvenience, and this is to ask you if you will not be good enough to hasten the matter to a close, and with the further request that you let me know by return mail just when we may expect the figures. If there is going to be any further delay in the matter, could you give me some tentative figures sufficient for banking purposes.

I will thank you very much for your immediate attention.

Yours very truly,
A. J. Ross, *President*
Valley Mills, Inc.

The auditor replied as follows on February 11 to the president of Valley Mills, Inc.:

Answering your letter of the 9th, we expect to complete the audit of the company's accounts by February 18 provided we can before that date resolve the following question relating to the inventory valuation.

There was on hand December 31, 1924, approximately 100,000 yards of a fabric called "Lowelty" which so far as we know

was not covered by sales orders. This fabric was intended for women's wear and if the style goes out of fashion before the present stock, or a substantial portion of it, is sold, a heavy loss may be sustained in disposing of the goods. We have not completed our investigation, but the trend of opinion seems to be that "Lowelty" is not good for another season except possibly in the higher grades. If this merchandise is to be disposed of at a profit on its present inventory value (which is at cost), it would seem to us that the company should be receiving substantial orders at this time.

We believe it is important to fix upon a conservative valuation for these goods and an expression of your opinion would be of great help.

The president of the company replied as follows two days later:

Dear Sirs:

Referring to your letter of the 11th we respectfully advise you that the best opinion that we can get from sources that should be well informed is that we should, within the next ninety days, market all the "Lowelty" cloth which we have in our inventory and at prices to show us at least a reasonable margin of profit over the prices at which it was shown on the said inventory.

For your information 95% of the "Lowelty" fabric which we have on hand is what is known as the higher grades. The market for this commodity should begin within the next two or three weeks. We are at the present time just between seasons. Unless all our information is in error there is no need for our making any further set-up for a prospective depreciation in our inventory values.

Trusting this gives you the desired information and with a further expression that we shall be indebted if you will expedite the completion of the final audit to the best of your ability, we are,

Yours very truly,
A. J. Ross, *President*
Valley Mills, Inc.

The information which the auditor obtained from other sources was as follows:

It is expected that the spring trade in the high colored "Lowelty" will be strong.

Not good for another season.

The market has been flooded with inferior merchandise in imitation of "Lowelty," but the feeling persists that the better grades have become staple.

Recent demands for "Lowelty" would be an indication that it is here to stay.

If you had been the auditor what disposition would you have made of the inventory item of the Lowelty fabric?

To what extent should an auditor obtain information from outside sources relative to items he is auditing?

30. MARCY CARTRIDGE CORPORATION

VALUATION OF INVENTORY: HOW DO CONTRACTUAL AGREEMENTS AFFECT THE VALUE OF INVENTORIES FOR BALANCE SHEET PURPOSES?

In 1918 the Marcy Cartridge Corporation was engaged in the manufacture of war ammunition including rifle, pistol, and machine gun cartridges and artillery primers. At the time of the Armistice the company was operating under two contracts, one with the Sanger Ammunition Company and the other with the United States Government.

The contract with the Sanger Ammunition Company dated April 5, 1917, provided for the manufacture and delivery of 9 MM cartridges, payment to be made at a fixed price for each 1,000 cartridges manufactured and delivered thereunder. Immediately after the signing of the Armistice the Sanger Ammunition Company requested the Marcy Cartridge Corporation to suspend production under the contract, to which the latter complied. On December 31, 1918, the Marcy Cartridge Corporation had on hand approximately 5,000,000 completed cartridges which had not been delivered or paid for, and in addition had a large amount of work in process and raw material acquired for the purpose of manufacturing cartridges under the contract. The value placed on this inventory as of December 31, 1918, by officials of the Marcy Cartridge Corporation who priced the finished cartridges at the contract figure and the goods in process and raw materials at cost, was $338,324.72. The market value of this inventory at December 31, 1918, was $99,121.39 but the company had no other customers for these cartridges.

Owing to cancellations of its own contracts by foreign agents late in 1918, and the inability to dispose of its products elsewhere, the Sanger Ammunition Company was declared insolvent and was unable to pay for the completed cartridges in accordance with its contract with the Marcy Cartridge Corporation. It was estab-

lished, however, that officers of the latter concern were aware of this insolvency before the end of 1918.

The second contract provided for the manufacture of and delivery to the United States Ordnance Department of completed cartridges manufactured according to specifications in the contract and at prices fixed by the terms thereof. In December, 1918, the Marcy Cartridge Corporation received and complied with a request from the Ordnance Department to suspend production under this contract. The request stated, however, that the company might expect settlement and adjustment by the negotiation of a supplemental contract which would permit a more prompt settlement and payment than the existing contract rendered practicable.

On December 31, 1918, the Marcy Cartridge Corporation had on hand completed cartridges, work in process, and raw materials for the Government contract which were valued at $915,110.77 by the company. This valuation was based on the cost of raw materials and work in process and on the contract price for completed cartridges as in the case of the Sanger Ammunition Company. The approximate market value of this inventory on this date was $289,519.29 but there was no market for these completed cartridges, raw material, or work in process for any purpose other than the intended one.

At the time of its annual audit the Marcy Cartridge Corporation had reached no settlement or agreement with either the Sanger Ammunition Company or the United States Government relative to these contracts. The auditors, therefore, were confronted with the problem of inventory evaluation on December 31, 1918. The company favored and had followed the policy of "cost or market whichever is lower" in the past and had kept its accounts on the "accrual basis."

How should an auditor have established these inventory items on the December 31, 1918, balance sheet?

31. JOHN T. CULVER COMPANY

REAL ESTATE DEVELOPMENTS: HOW SHOULD UNSOLD LOTS BE VALUED?

The John T. Culver Company was a large real estate company operating in an industrial city in the Middle West. Ever since its incorporation in 1890, it had been able to report satisfactory annual earnings except for a few years of general business depression. Its capitalization consisted of 50,000 shares of capital stock (par value $10 a share). These shares were listed on the local stock exchange but the majority of the shares were held by members of the Culver family, several members of which were directors or executives of the firm.

In 1898, the company had acquired a large tract of undeveloped land, known as the Westmont tract, on the outskirts of the city. Portions of the tract had been subdivided at various times into lots which were sold for home sites. The company had made numerous improvements to these areas before opening them for sale, *i.e.*, streets had been laid out and graded, curbing and sidewalks had been constructed, and the sewerage system had been extended. Most of these improvements had been made only as portions of the tract were opened for sale and it had been the policy of the company to charge all such expenditures against its expense of operations for the year in which the expenditures were made. Further, when lots were sold, the gross amount of the sales was credited against the original cost of the tract. The result was that in 1923, the unsold portion of the tract was carried at a very low valuation, much lower than it would have been if the original cost of the tract had been apportioned to the various sections. No objection to the company's practice had been made by Federal tax authorities, however. The books of the company had been audited by the same accountant for the past twenty years.

In 1923, when John T. Culver, the president, died, an executive of a real estate company in another city was elected to take his place. At the suggestion of the new president, Heinsman and Clark, a well-known firm of accountants, were employed to audit the books of the company. They were asked to submit a balance sheet as of June 30, 1923, and a profit and loss statement for the year ending on that date.

The new auditors felt that the valuation at which the unsold portion of the Westmont tract appeared upon the books was grossly incorrect. They estimated that earnings during past years had been understated by $500,000. However, to go back over a period of 25 years to determine what adjustments should be made seemed manifestly impossible, especially as certain records had been destroyed by fire in 1911.

Should the auditors attempt to restate for balance sheet purposes the value of the unsold portion of the Westmont tract? If so, what method should they adopt in assigning a new valuation to this property?

32. QUEEN CITY COTTON MILLS

STOCK IN PROCESS: MAY STOCK IN PROCESS BE OMITTED FROM THE BALANCE SHEET?

The New York partner of the Warren T. Wilson Company, public accountants and auditors, had occasion to refer to an audit report prepared by the Charlotte office of his firm for the Queen City Cotton Mills, which was located in a small city in North Carolina.

On a certified balance sheet submitted with the report, inventories were listed as follows:

INVENTORIES

Cotton	$549,163.91
Finished Goods	169,362.38
Supplies	26,002.40
	$744,528.69

Under the heading "Inventories," the following appeared in the report:

Raw cotton on hand on August 31, 1929, as shown by the cotton book, comprised a total of 5,667 bales, or 2,838,056 pounds, which has been valued at the August 31 market price of 19.35 cents per pound, market being lower than the cost of last purchases as revealed by the cotton book.

Sales of raw cotton during the year amounted to 3,343 bales or 1,543,410 pounds, sold at an average of 20.40¢/lb., or a total amount of $314,855.64.

Stock in process in the mill on August 31, 1929, comprised 325,350 pounds which has been valued at $85,210.68 for income tax purposes. This valuation has not been entered on the books and does not appear in the accompanying financial statements.

Finished goods comprised 465,042 pounds valued at $169,362.38.

A copy of the tax return which had been submitted to the Federal Government showed a tax had been paid on the difference between stock in process at the end of the year and that at the beginning of the year. The items were set up on the return as:

Stock in process not on books 9/1/28	$84,936.26
Stock in process not on books 8/31/29	85,210.68

Inasmuch as it is rather unusual to omit work in process from the balance sheet, the New York member inquired of his Charlotte partner why such a practice had been followed. The latter explained that stock in process had been omitted at the request of the management of the Queen City Mills. It was their contention that stock in process had no place as an asset on the balance sheet since it was of no value as partly finished material. In case of a shutdown, the stock in process would be scrapped.

The Charlotte partner said that while he did not necessarily accept this reasoning, he saw no objection to meeting the request. The capital stock of the company, he said, was almost entirely in the hands of three men, each of whom took an active part in the business.

Would you approve the omission of the item Stock in Process from the certified balance sheet?

33. WINFRED MINING COMPANY[1]

INVENTORY VALUATION: HOW SHOULD INVENTORY BE VALUED WHEN THE USE OF COST DISTORTS INCOME?

The company was in the metal mining and milling business. Its stock was listed on the New York Stock Exchange and the company was required to report quarterly to the exchange the net

[1] Adapted from an accounting question in *The Journal of Accountancy*, February, 1936, p. 153.

CONSOLIDATED PROFIT AND LOSS STATEMENT
PHILLIPS PACKING COMPANY, INCORPORATED, AND SUBSIDIARIES
FOR THE YEARS ENDED DECEMBER 31, 1935, 1934 AND 1933

Income	(1) 1935		(2) 1934		(3) 1933	
Sales:						
Net Sales:						
To Outside Customers	$8,997,462		$7,620,410		$5,753,844	
To Phillips Sales Co., Inc. Prior to April 1, 1933	—0—	$8,997,462	—0—	$7,620,410	113,483	$5,867,327
Brokerage:						
From Outside Sources	$ 49,116		$ 28,600		$ 18,744	
From Phillips Sales Company, Inc.—Prior to April 1, 1933	—0—	49,116	—0—	28,600	1,591	20,335
Total Sales Income		$9,046,578		$7,649,010		$5,887,662
Cost of Sales:						
Inventory—Beginning of Period	$2,057,014		$1,639,752		$1,108,424	
Purchases—Including Freight	6,006,050		4,779,098		3,974,986	
Manufacturing Expense	1,419,877		1,260,448		852,009	
Cost of Boat Operations	51,852		—0—		—0—	
	$9,534,793		$7,679,298		$5,935,419	
Less: Inventory End of Period	$2,936,609		$2,057,014		$1,639,751	
Cost of Free Goods included in Advertising	35,285		18,032		24,485	
Operation of Boats included in Outbound Freight	51,299		—0—		—0—	
Gross Profit	$3,023,193	6,511,600	$2,075,046	5,604,252	$1,664,236	4,271,183
		$2,534,978		$2,044,758		$1,616,479
Expense:						
Administrative and Selling		1,559,222		1,219,503		808,415
Operating Profit		$ 975,756		$ 825,255		$ 808,064
Other Deductions—Net		102,095		79,574		88,398
Profit Before Federal Income and Excess Profits Taxes		$ 873,661		$ 745,681		$ 719,666
Federal Income and Excess Profits Taxes		144,603		100,477		122,145
Net Profit for Period		$ 729,058		$ 645,204		$ 597,521

The beginning and ending inventories used in determining profit and loss for each of the three years were as follows:

Year Ended	Inventory	
	Beginning	Ending
December 31, 1933:		
Finished Stock	$ 905,289	$ 990,345
Raw Materials and Supplies	203,135	649,407
Total	$1,108,424	$1,639,752
December 31, 1934:		
Finished Stock	$ 990,345	$1,552,477
Raw Materials and Supplies	649,407	504,537
Total	$1,639,752	$2,057,014
December 31, 1935:		
Finished Stock	$1,552,477	$2,063,209
Raw Materials and Supplies	504,537	873,400
Total	$2,057,014	$2,936,609

Raw materials and supplies purchased from outside sources were valued at not in excess of the lower of cost or market.

The beginning and ending inventories of finished stock and of materials and supplies manufactured by the Company and its subsidiaries used in determining profit and loss for each of the three years are based on figures which officials of the Company estimated as being not in excess of cost. In the absence of adequate cost records, it is not possible to determine actual costs.

As a test of finished stock inventory values, the selling prices of a substantial part of the finished stock inventories were determined at the close of each of the above periods, based upon the price lists in effect at those dates. Sales in the month following each inventory date were made at prices generally in accord with such price lists. The tests showed an approximate percentage spread between the selling prices and the inventory valuations at the end of each year which was in excess of the annual rate of all distribution and general expenses.

The spread between list prices and inventory valuations of finished stock as of December 31 of each of the past three years, the gross profit margin ratio, and the ratio of expenses to sales income for each of those years are indicated on page 288:

Year Ended	Approximate Spread Between List Prices and Inventory Values	Gross Profit Margin Ratio to Sales Income for Year	Expense Ratio to Sales Income for Year (Consisting of selling, general and administrative expenses, plus other deductions less other income)
December 31, 1933	32.20%	27.46%	15.23%
December 31, 1934	31.80	26.73	16.98
December 31, 1935	20.56	28.02	18.37

During the year ended December 31, 1935, there was a decline in selling prices, and as between the beginning and the end of 1935 the spread between inventory values and list prices of finished stock showed a decline from approximately 31.80% to 20.56%. Notwithstanding this decrease, the consolidated profit and loss statement for 1935 showed a gross profit margin not less than the gross margin realized in the two preceding years.

In the absence of adequate cost records, there is no method of verifying whether or not the inventories of finished stock and of materials and supplies manufactured by the Company and its subsidiaries at the beginning and end of each accounting period were stated at not in excess of cost. Market values or replacement costs also were not available. Had it been possible to ascertain actual costs or the lower of cost or market, the profits computed for any period and the trend of earnings reflected in the Profit and Loss Statements might have been different.

A major portion of the earnings normally has been derived from operations during the six months' period from April 1 to September 30 of each year, in which period the seasonal pack of certain products, such as peas and tomatoes, is manufactured and largely sold. Earnings are therefore to an important extent dependent upon conditions affecting costs, supply of raw materials and selling prices during this six months' period of each year.

A stockholder with large holdings in this company asks you as a public accountant to interpret for him the meaning of the notes appended by the auditors to the profit and loss statements.

35. PIEDMONT MANUFACTURING COMPANY

INVENTORY VALUATION: HOW MAY OVERSTATEMENT OF COAL INVENTORY BE AVOIDED?

The Piedmont Manufacturing Company used large quantities of coal in its manufacturing processes in the running of its power plant. Although records for physical quantities of coal were kept, inventory costs and charges to operating accounts were based upon a "standard fuel ton," the heat equivalent of one ton of coal, each pound of which, when burned, would release 13,750 B.t.u. of heat energy.

The average heat value of each shipment of coal purchased was determined by tests of samples in the company's laboratory and the equivalent standard fuel ton thus determined for entry in the records. Heat actually developed in use served as the basis for charges to the operating accounts and credits to the inventory on the first-in, first-out basis. The opening inventory value was represented by the current average price per standard fuel ton in the inventory.

Since weighing the entire coal pile for inventory-taking purposes was impractical, physical overage and shortage were indicated by survey measurements of the pile. No adjustment was made unless the discrepancy exceeded 10% of the physical quantities as shown on the books, in which case the book figures for physical quantity, standard fuel tons on hand, and average costs were all adjusted in the same proportion.

An abstract of the coal inventory account for the first 6 months of 1937 appears on page 290. In July, 1937, although the operating executives of the company did not wish to disturb the practice of relating coal-accounting records to heat equivalents, the financial executives believed that the existing treatment overstated the coal inventory on the balance sheet; this they wished to avoid.

Would you suggest any changes in the accounting procedure or do you believe the June 30, 1936, figure for coal inventory to be fairly stated?

ABSTRACT OF COAL INVENTORY ACCOUNT

	Physical Tons	Standard Tons	Price	Book Amount
January 1, 1937, on hand per books	25,000	25,525	$4.6523	$118,750.00
January purchased	15,000	(A) 14,730	Cost	67,500.00
January used	20,385*	(B) 20,000*	4.6523	93,046.00*
	19,615	20,255	4.6015	$ 93,204.00
February purchased	14,000	(A) 13,776	Cost	64,400.00
February used	16,869*	(B) 16,600*	4.6015	76,384.90*
	16,746	17,431	4.6595	$ 81,219.10
March purchased	13,000	(A) 12,857	Cost	60,450.00
March used	15,106*	(B) 14,900*	4.6595	69,426.55*
	14,650	15,388	4.6947	$ 72,242.55
April purchased	11,000	(A) 10,956	Cost	51,425.00
April used	13,026*	(B) 12,900*	4.6947	60,561.63*
	12,614	13,444	4.6940	$ 63,105.92
May purchased	9,000	(A) 9,162	Cost	42,300.00
May used	10,979*	(B) 11,000*	4.6940	51,634.00*
	10,635	11,606	4.6331	$ 53,771.92
June purchased	7,000	(A) 7,245	Cost	33,250.00
June used	8,967*	(B) 9,100*	4.6331	42,161.21*
June 30 inventory before adjustment	8,668	9,751	4.6006	$ 44,860.71
Excess of coal on hand (physical tons) as indicated by survey of pile, June 30, over book figures	900	(C) 1,012	4.6006	4,655.81
Inventory, June 30, adjusted	9,568	10,763		$ 49,516.52

Standard Tons—symbols

(*A*) As shown by samples tested in laboratory at time of purchase.

(*B*) Based on heat actually developed $\dfrac{\text{B.t.u.}}{(13{,}750 \times 2{,}240)}$.

(*C*) Converted from physical tons at average ratio for inventory before adjustment.

* Red.

36. HOOD VALLEY LUMBER MILL

INVENTORY VALUATION: HOW SHOULD LUMBER BE VALUED FOR BALANCE SHEET PURPOSES?

The Hood Valley Lumber Mill operated a sawmill which manufactured rough and dressed fir lumber and some hardwood for commercial uses. Only a small amount of hardwood was cut and as this was generally sold in the rough it was deemed

unnecessary to grade it for inventory purposes. The mill was a member of a lumber manufacturer's association which had established quality standards for grading lumber and it abided by these grade designations which were "B & B," No. 1, No. 2, and No. 3; "B & B" being the best grade and No. 3 the poorest. The company's inventory records were accurately kept but despite this fact the valuation of this item was always a current problem.

Accountants and auditors for the mill recognized that there were three principal methods of valuing inventory which were generally adopted by lumber manufacturers for balance sheet purposes, namely:

(*a*) "Fixed price"[1]
(*b*) Selling price, less a deduction for handling charges, etc.
(*c*) Cost price

It had formerly been the company's policy to value its inventory under the "fixed price" method which provided a minimum value for each grade of lumber manufactured. The auditors took exception to this policy, however, on the ground that it conveyed no approximation of current value. Valuing the inventory on the basis of selling price less charges was also considered unsatisfactory except when market prices were considerably below the cost price and a drastic inventory reduction was found to be necessary.

Under the third, or average cost, method the valuation assigned to the inventory did not always state the true condition since service costs of sawing and planing the lower grades of lumber were practically the same as for the higher grades, and not infrequently the cost of dressing low-grade lumber exceeded the market prices which could be obtained for it. Consequently, if the inventory at the balance sheet date contained a large percentage of dressed low-grade lumber, it was very likely to be valued too highly if this method was used.

[1] "The fixed price for each grade of lumber should be based on a price below which the market has never fallen, less a deduction for handling charges, breakage and de-grade, selling expenses, etc. It practically means that the lumber inventory is included at a price at which it could be disposed of at any moment. . . . Once the price under this basis is "fixed," it becomes, in the absence of special conditions, the inventory price for that particular grade of lumber at each stocktaking period." (A. F. Jones, "Lumber Manufacturing Accounts," p. 60.)

Still another method developed by some accountants, though not generally used, was the "allocated cost" basis in which an attempt was made to distribute the average cost by grades, thus making the higher grades bear a large proportion of the cost. This was accomplished by finding the average market price for all grades of dressed lumber produced and the average market price for all grades of rough lumber produced. The ratio of the market price for any one grade of dressed lumber to this average of the market prices for all grades of dressed lumber was expressed on a percentage basis; likewise, the ratio for any one grade of rough lumber to the average of the market prices for all grades of rough lumber was similarly expressed. Percentages thus obtained were applied against the average cost of production to find the allocated cost by grades. This was done by multiplying the average cost of production for dressed lumber, or for rough lumber, by the percentage determined for each grade of dressed, or of rough, lumber. When the total allocated cost value was thus determined, this could be compared with the actual market value and the lower of these two used for the financial statements. Under all circumstances, however, the auditors had to bear in mind that the inventory should be treated as a unit, and a uniform method of valuation applied to all grades.

Actually, the accountants, in preparing a balance sheet as of December 31, 1928, decided to use the average cost method and proceeded with the following information at hand:

INVENTORY—DECEMBER 30, 1928

Fir:			
B & B—dressed	883,000	board	feet
" " "—rough	1,646,000	"	"
#1—dressed	934,000	"	"
"—rough	718,000	"	"
#2—dressed	916,000	"	"
"—rough	1,010,000	"	"
#3—dressed	300,000	"	"
"—rough	214,000	"	"
Timber—dressed	none		
" —rough	27,000	"	"
Total Fir	6,648,000	"	"
Hardwood:			
Rough	54,000	"	"
Total Inventory	6,702,000	"	"

The sawmill cut for December 31, 1928, was:

B & B—rough	17,000	board feet
#1— "	16,000	" "
#2— "	26,000	" "
#3— "	6,000	" "

Shipments of dressed lumber on December 31, 1928, were:

B & B—	28,000	board feet
#1—	7,000	" "
#2—	64,000	" "

In the process of manufacture, it had been found that a loss in board feet of 5% was incurred in the planing mill when lumber was dressed. Likewise, the drying process always revealed defects which made it necessary to grade down about 20% of each grade of rough lumber to the next lower classification; *i. e.*, as a result of the reclassification necessary after the drying process about 20% of the "B & B" grade would be classified as No. 1.

The average cost of production for dressed lumber per the company's records was $24.40 per thousand board feet, and $20.50 per thousand board feet for rough lumber. Approximate market prices as of the balance sheet date were as shown in the table below.

	Rough	Dressed
B & B	$21.00	$28.00
#1	18.00	24.00
#2	16.00	22.00
#3	14.00	20.00
Timber	12.00	
Hardwood	30.00	

Prepare schedules showing the inventory values under the average cost basis, the allocated cost basis, and the market basis. Which of these values would you be inclined to use in a statement that you were to certify?

Discuss the methods of inventory valuation outlined in the case and indicate your choice, giving reasons therefor, or, if you prefer another method which is not outlined, describe your method.

37. HOPKINS DEPARTMENT STORE—PART V

INVENTORIES: WHAT SCHEDULES SHOULD AN AUDITOR MAKE UP IN VERIFYING INVENTORIES?

The Hopkins Department Store accounted for its merchandise by the retail inventory method which provided the store with a perpetual departmental inventory record. The inventory at the beginning of the period was entered for each department at both cost and retail figures, and all purchases which were made during the period were entered likewise at both cost and retail prices; the total retail figure was adjusted to include additional mark-ups less additional mark-up cancellations. Thus, total cost figures and total retail figures were available for all merchandise handled during the period. From the total retail figure was subtracted the net sales figure for the period plus mark-downs (and downward price changes for any other reasons) less mark-down cancellations to obtain the book figure for the retail value of merchandise in stock.

A physical inventory was taken once each year as of December 31 at the retail figures on the tickets on the merchandise in stock. Any discrepancy between the retail book inventory figure and the physical inventory figure was a retail stock shortage or overage, as the case might be. To ascertain the cost or market valuation of the closing inventory, the complement of the percentage of mark-up was applied to the physical retail inventory figure.

In conjunction with the retail inventory method the Hopkins Department Store kept a Department Sales Audit Record, a Merchandise Register, and a Price Change Report. The summary totals from all these reports were recorded on a Gross Profit Analysis Sheet.

The sales were recorded daily by departments on the Department Sales Audit Record, a separate card being used for each department. The month and department name were entered at the top of the card while each day of the month covered one line. The columns were headed as follows:

Day	Sales		Returns	Net Sales
	Cash	Charge		

The Merchandise Register was arranged with one department to a page and had the following columns:

Date	Invoice No.	Name	L. F.	Retail*	Cost	Mark-up	Terms

* Cost plus mark-up.

Mark-downs, mark-down cancellations and additional mark-ups were made by using a Price Change Report. These reports were in the form of slips or tickets and had the columnar headings given below:

Items	Sup-plies	Style Num-ber	Origi-nal Retail	Last Retail	Mark-down Price	Mark-up Price	Mark-down Cancel Price	Differ-ence	Quanti-ty	Unit	Amount

Other spaces were provided for recording the reason for changing the price, department head's signature, department, and the manager's approval.

The Gross Profit Analysis had one page for each department and a summary page for the store. It showed by months the current and accumulated (since last closing) respective gross profits of the different departments and their deviations. Each page covered a one-year period as of December 31. The line titles of each page were as follows:

Inventory	January	Accumulative	February	Accumulative	December	Accumulative

and the columnar headings were:

Period	Purchases				Inventory Deductions		Inventory		Cost of Sales	Gross Profit	
	Retail	Cost	Mark-up	%	Mark-downs	Sales	Retail	Cost		Amount	%

The per cent in the second column was the ratio of mark-up to the retail price. The per cent in the last column was obtained by dividing Gross Profit by Sales. Only cumulative figures were shown in the inventory columns and for convenience the cumulative figures were entered in red.

All of the detailed records described above were checked against the Gross Profit Analysis Sheets in the following manner: the entire Merchandise Register for one month was checked

against the Gross Profit Analysis and the totals for one department in the Merchandise Register were checked against the Gross Profit Analysis for the other months. The Department Sales Audit Record and Price Change Reports were similarly examined and checked. No errors were found in any of these records.

The physical inventory was taken on special inventory sheets which had the following columnar headings:

INVENTORY COUNT

Department 9			Page 3		Dept. 9 Page 3
Quantity	Unit	Item	Retail	Extended Retail	Extended Retail

Extensions were made by the persons taking the inventory, and the amounts were inserted in the last column. That part of the sheet was then removed and the extensions were figured and entered in column five in the office.

From 40% to 60% of the extensions on each inventory sheet were checked and all footings were verified by the auditors. The footings from the inventory sheets of each of the departments were listed:[1]

Page	Dept. 1	Page	Dept. 2	Page	Dept. 3	Page	Dept. 4
1	$ 3,027.12	1	$ 3,176.45	1	$ 2,667.94	1	$ 2,876.71
2	2,543.17	2	2,975.32	2	2,763.91	2	2,689.37
3	2,245.61	3	3,496.21	3	1,863.27	3	3,096.72
4	2,789.67	4	3,672.49	4	2,039.18	4	2,769.42
5	3,127.96	5	2,826.76	5	2,643.19	5	2,689.71
6	2,943.72	6	3,321.74	6	2,249.31	6	3,124.32
7	2,446.32	7	3,271.59	7	2,137.93	7	3,014.27
8	2,718.96	8	3,832.38	8	1,938.76	8	3,276.28
9	2,639.75			9	2,079.63	9	2,943.17
10	3,204.34		$26,572.94	10	2,448.92	10	2,671.35
				11	2,694.91	11	2,531.32
	$27,686.62			12	2,683.79	12	2,736.82
				13	3,079.65	13	2,438.91
				14	2,984.30	14	2,871.51
						15	2,657.85
					$34,274.69		
							$42,387.73

[1] The list is condensed because the inventory sheets were in detail. Footings only are given for each page but the correct totals appear herein.

Page	Dept. 5	Page	Dept. 6	Page	Dept. 7	Page	Dept. 8
1	$ 2,799.42	1	$ 3,387.61	1	$ 1,703.05	1	$ 3,506.70
2	2,016.65	2	3,106.74	2	1,927.63	2	3,796.25
3	2,216.79	3	3,469.23	3	2,236.41	3	2,917.63
4	2,469.71	4	2,934.75	4	2,043.97	4	3,367.92
5	2,391.34	5	3,069.42	5	1,967.51	5	3,576.13
		6	3,545.21	6	2,013.42	6	3,010.87
		7	2,916.75	7	1,589.29	7	3,765.44
		8	3,724.31	8	1,876.91	8	3,948.67
		9	3,547.92	9	1,656.72	9	3,791.32
		10	4,167.83			10	3,286.25
						11	3,426.67
						12	3,548.92
						13	3,713.65
						14	3,432.32
						15	3,619.86
	$11,893.91		$33,869.77		$17,014.91		$52,708.60

Page	Dept. 9	Page	Dept. 10
1	$ 2,596.18	1	$ 3,010.84
2	2,319.85	2	2,649.32
3	2,781.32	3	3,247.76
4	2,694.31	4	3,016.71
5	2,145.80	5	3,134.31
		6	2,876.54
		7	2,743.21
		8	3,146.25
		9	3,344.22
		10	2,975.64
		11	3,013.10
		12	3,176.53
		13	2,901.16
		14	3,146.93
		15	3,586.13
	$12,537.46		$45,968.65

The final accumulated percentages of mark-ups from the Gross Profit Analysis Sheets were used to change the inventory figures from the retail price to the approximate cost price. The accumulated percentage mark-ups for the different departments for 1927 were as follows:

Dept. 1	35.43%	Dept. 6	30.17%
" 2	26.72	" 7	38.18
" 3	31.68	" 8	38.56
" 4	37.73	" 9	32.92
" 5	34.18	" 10	24.86

Price amounts were tested to obtain a check upon the accuracy of the work performed by the persons who took the inventory. From the inventory sheets of the different departments, items representing the largest amounts were selected and listed. The prices and number of articles in stock were then compared with this list. As a period of time had elapsed since the inventory had been taken, discrepancies were found. A few articles had been sold, others had been returned to the warehouse, and others had been marked down or up as the condition dictated. In the case of mark-ups the authorization for the changes was verified and checked. On the whole it was apparent from the inventory audit that a high degree of accuracy had been maintained in taking the inventory.

In addition to this verification the following statement certifying the accuracy of the inventory was secured from the manager:

> I hereby certify that the inventories as of December 31, 1927, were taken under my supervision. The inventories were taken by actual count, weight, or measurement. This verification of physical quantities was made at the end of the year or as close thereto as practicable.
>
> Inventories were valued at retail and reduced to approximate cost by application of the complement of the percentage of gross mark-up by departments to the retail values. Deductions were made for damaged, obsolete, and shop-worn goods.
>
> Signed: F. E. Mason, *Manager*

Were the tests which were made sufficient? Prepare suitable schedules and carry necessary adjustments to working trial balance schedule for this phase of the audit. Of what value was the manager's certification?

Note: It is suggested that the student refer to Hopkins Department Store, Part VIII, in conjunction with this case.

CHAPTER VIII

AUDIT OF FIXED ASSETS

38. ATLANTIC POWER AND LIGHT COMPANY

EQUIPMENT: SHOULD THE COST OF NEW BUSINESS BE INCLUDED IN A CAPITAL ACCOUNT?

While making their audit of the Atlantic Power and Light Company, for the year ended December 31, 1931, the auditors discovered that the company had entered into several contracts for the sale of industrial power to companies that formerly maintained their own generating equipment.

On April 12, 1931, the Atlantic Power and Light Company had purchased certain generating equipment from two ice companies for $50,000, in connection with its acquisition of new business, and in addition had installed certain substation equipment on the properties of the ice companies at a cost approximating $20,000. The purchase price, plus the installation cost of the substation, was charged to the fixed capital account, Cost of Plant and Equipment Purchased, although the substation was deeded to one of the ice companies immediately following construction. It was known at the time of the contract that the equipment purchased by the power and light company from the ice companies could not be used and that the price paid was in excess of any realizable value.

It was also discovered that on July 15, 1931, the Atlantic Power and Light Company had entered into an agreement with the Willis Cotton Manufacturing Company whereby the latter was to purchase from the power and light company its entire power and lighting requirements. The power and light company in turn agreed to purchase the Diesel equipment then in use by the Willis Cotton Manufacturing Company. A price of $20,000 was stipulated, and upon payment of the whole amount, was debited to the fixed capital account, Cost of Plant and Equipment Purchased. Here, again, it was known that the price paid for the consumer's equipment was excessive. On November 14, 1931, the power and light company sold the Diesel equipment for $4,600. The balance of $15,400 was debited to Retirement Reserve.

The management of the company contended that in each of these instances the company acquired a substantial asset in the form of earning power.

Would you as an auditor have approved these entries? If not, what accounting treatment would you have suggested?

39. AIRCASTLE THEATRE—No. 2

IMPROVEMENTS: WHAT INFLUENCE MAY A STATE ORDINANCE HAVE UPON THE FIXED ASSETS OF A BUSINESS?

In the latter part of August, 1927, the owner of the Aircastle Theatre, Mr. C. H. Bartram, received a letter from the state Department of Public Safety shortly after a visit by the state building inspector, stating that another exit and certain additional lighting would have to be provided in the theatre to comply with the state laws. Mr. Bartram quickly conferred with the state inspector and made arrangements to correct the situation.

Specifications were drawn up by an architect and two contracts were signed on September 19, 1927, covering construction in accordance with these specifications. One contract for $3,664 was signed with the F. Willis Company for the construction of a fire tower. The other was a $775 contract with Lewis E. Wesley, Inc., for the installation of lights in the fire tower and in the theatre itself. Under each of these contracts the architect was to estimate at the beginning of each month the per cent of the contract that was finished. The Aircastle Theatre was to pay on or about the tenth of the month 85% of the price of the estimated portion of the contract work completed during the previous month. When the work was substantially completed, the theatre was to pay enough more to bring the total payments up to 85% of the total contract. Forty-one days later the balance (15%) was due.

In accordance with this agreement, on November 1, 1927, the architect presented an estimate for the work done on the fire tower, and the theatre sent a check to the F. Willis Company for $1,645.55. The electrical contract had not been started. No

estimate on either contract was made on December 1, because it was expected that the work would be entirely finished before the end of the year. On January 2, 1928, Mr. Bartram received a letter from the architect which stated that the two contracts were practically complete. The state building inspector, however, found that the fire tower was an inch too narrow to comply with the state ordinance, and all further payments were, therefore, delayed. Investigation of the original specifications showed that the error had been the fault of the architect, but he was impecunious and there was little hope of recovery from him. F. Willis Company was authorized to widen the fire tower and later two checks for $1,200 and $500, respectively, were sent to the company to make up the 85% of the total contract. The 15% was held up pending final settlement.

On the books of the theatre the Improvements Account showed the following entries:

November 30, 1927—F. Willis	$1,645.55
November 30, 1927—C. Russell for additional lavatory facilities	237.81
January 31, 1928—F. Willis	1,200.00
February 29, 1928—F. Willis	500.00
	$3,583.36

If you were auditing the accounts of this theatre for December 31, 1927, what disposition would you make of the costs of the fire tower, of the additional lighting, and of the new lavatory facilities?

Would your opinion differ as to the fire tower had the error in construction been due to the contractors and not the architects?

40. WRIGHT FOUNDRY COMPANY

MACHINERY ACCOUNT: HOW SHOULD A MACHINERY ACCOUNT BE AUDITED?

A transcript of the Machinery Account of the Wright Foundry Company from January 1 to April 2, 1926, is given as follows:

MACHINERY

Date	Ref.	Description	Dr.	Cr.
1926				
Jan. 1		Balance	$525,627.94	
8	C. S. 116	Freight	23.68	
22	118	"	2.50	
31	Inv.	See detail	3,212.17	
15	P. C. 40			$ 10.00
31	C. M.			.50
Feb. 13	C. S. 121	Freight	27.63	
15	C. S. 121	"	136.80	
28	Inv.	See detail	11,539.38	
27	C. S. 122	Freight	5.60	
28	J. E. 24	Removed from inventory		3,382.50
	J. E. 26	Transfer from Fin. Mat'l Dept.	1,594.93	
Mar. 2	C. S. 123	Freight	16.44	
31	Inv.	See detail	4,688.16	
	J. E. 48	Removed from inventory		7,358.30
	J. E. 50	Accounts Payable	2,500.00	
	J. E. 52	Reverse of above		2,500.00
Apr. 2	C. S. 127	Freight	15.55	
			$549,390.78	$13,251.30

The voucher register for the month of January, 1926, showed that the following vouchers were listed in the "Miscellaneous" column with the word "Machinery" opposite each amount:

VOUCHER REGISTER

Voucher Number	Vendor	Item	Amount	
1063	W. D. Smith Elec. Co....	1—Non-reversing 75 H. P. starter New Power Plant		$ 271.00
1203	C. A. Dodge Co.........	Pipe Line at Power House		92.70
1226	Union Gear & Mach. Co.	2—20" Drop hangers for Tumbling Mills Chip Rm.		32.00
1237	Boston Gear Works	Drive and span on Tumbling Mills	$104.75 37.75	142.50
1272 1/16	Warren Steam Pump Co.	1—1½" type DB-11 centrifugal pump — Power House		170.00
1309	Osborne Mfg. Co.	1—No. 401 Roll Over Jolt Moulding Machine		950.00
1315	Skippstedt Erickson Co.	1—Type "A" Multiple Core Machine		385.00
G.E.J. 1378	Grindle Fuel Equip. Co.	1—3-lb. hopper and fan support 1—Elevator chute Power Plant		876.00
1428	Edison Mfg. Corp.	1—KT 512-8 15 H.P. motor—sliding base—pulley—compensator and relay—motor for Potter & Johnson machine		263.50
1478	Edison Mfg. Corp.	Transportation charges on 1 Potter & Johnson machine		29.47
				$3,212.17

Journal entry 24, dated February 28, 1926, was as follows:

		Dr.	Cr.
Depreciation Reserve........................		$3,382.50	
To Machinery...........................			$3,382.50
Removal of the following machines:			
1 100 H. P. Oil engine.....................	$2,387.37		
1 Switchboard	132.68		
1 Generator	862.45		
(Purchased prior to 1/1/18. Depreciation accrued 8 years, 3 mos.)			
	$3,382.50		

What evidence would you examine in auditing the ledger account as shown above? Substantiate your reasons.

41. GORMAN COMPANY

FIXED ASSETS: WHAT VERIFICATION SHOULD BE MADE OF FIXED ASSETS FOR A BALANCE SHEET AUDIT?

The Gorman Company manufactured a specialized line of chemical products which were sold entirely to the industrial trade. The main plant and general offices were located in Boston; in 1932 a plant in Chicago was acquired to facilitate trade in the western part of the United States. Shaw and Sons, a nationally known firm of public accountants, had made annual balance sheet audits of the company since 1922.

The procedure, with which the accountants were familiar, in accounting for fixed assets was as follows: Whenever an expenditure was to be made upon the plant, for either additions or repair work, the plant foreman seeking the expenditure filled out a "Request for a Shop Order" upon which he stated the work to be done and sometimes the reasons therefor. The request was then submitted to the engineering department where, if approved, a "Shop Order" with estimated costs was made out and forwarded to the treasurer. The treasurer's approval constituted authority for beginning the work.

Upon the shop order were noted all actual expenditures, including cost of new equipment, as well as cost of materials and

direct labor. It was a policy of the company to make no allowance for overhead expense in new construction work. As soon as the work under a particular shop order was finished, the order was marked as having been completed and was sent to the accounting offices where it formed the basis for entry in the books of account. The decision as to whether an item should be capitalized or charged to operations was left to the discretion of the treasurer.

In the accounting offices the shop orders were entered in a Shop Order Register, in which there were columns for (1) Shop Order Number, (2) each of the general ledger accounts for fixed assets, and (3) Plant Expense. Plant Expense was further divided to show both explanation and amount. The register thus showed the distribution of the expenditures made under shop orders. Inasmuch as no disbursement could be made except under an authorized shop order, the register accumulated the information regarding all expenditures on fixed assets.

The Shop Order Register formed the basis for posting to the ledger accounts. The totals of amounts in each of the fixed asset columns were posted monthly as debits to the asset accounts in the general ledger, whereas the amounts were posted in detail to a plant ledger in which all the machinery, etc., was kept by individual units. The total of the items in the plant ledger equalled the amounts in the general ledger fixed asset accounts. The plant expenses in the last column of the Shop Order Register were posted in detail to the proper expense accounts.

Account	Boston	Chicago
Land and Siding	$ 12,185.80	$ 5,432.27
Main Building	51,327.13	5,571.31
Other Buildings	11,895.70	
Machinery	12,381.11	4,187.55
Boiler Plant	3,827.63	
Tanks and Piping	13,681.73	19.40
Electric Equipment	3,504.25	205.85
Laboratory Equipment	1,938.39	
Miscellaneous Equipment	20,404.20	483.67
Office Furniture and Fixtures	4,050.41	264.66
Dryer	1,976.80	
	$137,173.15	$16,164.71

When making their examination of fixed assets for the year ended December 31, 1933, the auditors compared the closing balances of the preceding year in their working papers with the figures for beginning balances of the current period in the company's books and found them to be in agreement. The fixed asset accounts in the general ledger showed the balances as of December 31, 1932, as shown in the table on page 304.

The reserves for depreciation on all fixed assets as of December 31, 1932, stood at $21,845.50 on the Boston plant and $1,362.56 on the Chicago unit. Depreciation was figured at 3½% on the Main Building at Boston, 5% on the Boiler Plants, 10% on Other Buildings, Machinery, Tanks and Piping, Electric Equipment, Laboratory Equipment, Miscellaneous Equipment, and Office Furniture and Fixtures, and 25% on Automobiles. For the year 1933 the company charged to depreciation expense $8,867.05 on the Boston plant and $2,065.55 on the plant in Chicago. As of December 31, 1933, the reserves for depreciation showed: Boston, $30,504.73; Chicago, $3,428.11.

Total additions to and deductions from the assets for the year under audit were as shown in Exhibit 1.

Exhibit 1

Additions to and Deductions from the Assets of the Gorman Company for the Year Ended December 31, 1933

Land and Siding:	
Boston—Additions	
Grading and Filling	$ 6.75
Chicago—Additions	
Grading Yard and Driveway	57.45
Five Yards Garden Loam	11.25
Improvement on Grounds	23.43
Grass Seeds	5.75
Deductions—Refund from Railroad Company on Siding Property	34.02
There was no change in the main building in Boston.	
Other Buildings:	
Boston—Additions	
Building New Pump House over Tank	205.02
Installation of Heating Coils in Building No. 4	75.95
Reinforcement of Shed	31.88
New House for Tank No. 4	155.34
Chicago—Additions	
Wiring of Plant by Miller Electric Company	1,002.60*
Lumber Used	145.50
Erection of Fence	34.05
Pump and Motor	346.75*
Construction of Garage	300.00*
Barrow & Son, Contracts	1,800.00*

EXHIBIT 1 (*Continued*)

ADDITIONS TO AND DEDUCTIONS FROM THE ASSETS OF THE GORMAN COMPANY FOR THE YEAR ENDED DECEMBER 31, 1933

Machinery:	
Boston—Additions	
Compressor	$ 402.86
Express on Compressor	15.84
Aerial Grinder	300.00
⅜" Drill	145.00
Grinding Mill	1,800.00
Installation of Pump in Grinding Mill	76.85
Installation of Kettle—Kettle Section	270.61
Deductions—Discard of Lead Lined Tanks	365.67
(Depreciated to extent of $182.82)	
(No salvage value)	
Chicago—Additions	
Installation of Mixer	222.81*
Freight	84.33*
Labor and Material	372.25*
Overhauling 1,000 Gallon Mixer	87.53*
Installation of Kettle and Drive	217.80
Boiler Plant:	
Boston—Additions	
Replacing Pump in Boiler Room	55.11
(Cost of new pump $180.11, less cost of old $125.00, 20% depreciated, no scrap value)	
Chicago—Additions	
Kane Boiler	398.00*
Setting up and Connecting Boiler	7.12*
Tanks and Piping:	
Boston—Additions	
Installation New Tanks in Building No. 4	675.80
Drain	274.25
One 10,000 Gallon Riveted Steel Storage Tank	677.13
Installation New Tank	373.28
Deductions—Refund of License Commission	2.40
Chicago—Additions	
Installation Pipe Lines	170.35*
Vertical Storage Tank	950.00*
Foundation	5.55
Electric Equipment:	
Boston—Additions	
Electric Work on Grinding Mill	224.75
Installation of Motor for above	147.95
Lighting for New Pump House	16.17
Chicago—Additions	
1,800 Watt Edison Heater	31.35*
Magna Ray Heater	22.83*
Laboratory Equipment:	
Boston—Additions	
Installation of Lighting System	115.30
Installation of Ventilator System in Laboratory	174.41
Chicago—Additions	
Distilling Apparatus	87.40*
Balance and Weights	76.35*
4 Graduated Cylinders	3.50*
First Aid Cabinet	9.71*

EXHIBIT 1 (*Continued*)

ADDITIONS TO AND DEDUCTIONS FROM THE ASSETS OF THE GORMAN COMPANY FOR THE YEAR ENDED DECEMBER 31, 1933

Miscellaneous Equipment:	
Boston—Additions	
Installation New Pumps	$ 154.25
Heating Apparatus in Building No. 4	798.50
Building Shelves in Laboratory	250.66
Erecting Balcony in Storehouse	220.43
Shelving Equipment	98.35
Graham Rotary Pump	108.44
Transfers from Chicago—	
One Centrifugal Pump	100.00
One 1,000 lb. Fairbanks Scale	50.00
Chicago—Additions	
Two 1,041 Dormant Scales	349.75*
Two Stencil Machines	146.95*
Erecting Trolley Track	125.87*
Installation of Blower Fan and Ventilating System in Manufacturing Building	130.36
California Scale	23.00
Deductions—Transfers to Boston—One Centrifugal Pump	100.00
One 1,000 lb. Fairbanks Scale	50.00
Office Furniture and Fixtures:	
Boston—Additions	
Cabinet with Roll Top	195.80
1 Typewriter	110.46
5 Ediphones	1,074.19
Chicago—Additions	
Calculating Machine	385.80*
1 Adding Machine	340.15*
1 Safe	205.00
Desk, Desk Chair and Baskets	134.95
1 Work Table	84.10*
Automobiles:†	
Boston—Additions	
Ford Coupe	605.00
1 Standard Tire and Tube	10.78
Chains	4.50
Chicago—Additions	
Ford Coupe	647.00*
Bumper for Ford	9.12*
Dryer:	
Boston—Additions totaling $2,102.74 were made, but the account was written down to $200, representing scrap value, and the balance was charged to obsolescence as an expense.	

* Additions of January, 1933, when relatively high expenditures were incurred in the adaptation of the Chicago plant to the company's productive needs. All other capital expenditures were made over the entire year. Depreciation on the former was computed from the month of purchase; on the latter from July 1, 1933.

† The Boston automobile was purchased August 31, 1933.

How would you as an auditor verify the fixed assets as of December 31, 1933?

Prepare suitable schedules for your working papers.

How would your procedure vary, assuming the same system of accounts, if plant additions were more numerous and for larger amounts?

42. DAVIS, WILLEY COMPANY

LEASES: HOW SHOULD A SUBLEASE BE SHOWN ON THE STATEMENTS?

The public accounting firm of Harley & Blake was engaged to make a balance sheet audit in behalf of creditors of Davis, Willey Company, which ran a chain of stores selling a general line of merchandise in the lower price ranges. Few of the stores occupied by the company were located on real estate belonging to it; most of the stores were held on lease for periods of 5 to 20 years. When Harley and Blake examined the leases, they found one for a 10-year period on the property at 10 East Street, Boston, at which address they found the company had no store. This lease had already run 2 years by December 31, 1933, the date of the audit. It called for rental payments of $15,000 per year, which amounts appeared in the cash disbursements book and were supported by canceled checks. Further investigation revealed cash collections for the last 2 years of $21,000 per year from the Novelty Company, which had subleased the premises. Payments and collections had respectively been debited and credited to a Rent account, which account had been closed each year into Profit and Loss. No mention of leases was made on the company's balance sheet which Harley & Blake were asked to certify.

Should any mention of the leases be made on the company's certified balance sheet?

If so, state what it should be and show how you would derive any figures to appear there.

43. MACK DISTRIBUTING CORPORATION

FIXED ASSETS: HOW SHOULD THE ACQUISITION OF A SPRINKLER SYSTEM BE SHOWN ON THE STATEMENTS?

The Mack Distributing Corporation conducted a wholesale grocery business. With the exception of one qualifying share, the entire capital stock of the company was owned by Mr. William Adams, the treasurer, and Mr. John Mack, the president. Both men were engaged solely in the management of the business and despite the corporate form of organization they considered themselves as partners. The corporation and one of its two fully-owned subsidiaries occupied two adjoining buildings, one of which was owned by the parent corporation. The parent corporation held a mortgage on the second building, which was owned jointly by Adams and Mack as individuals, they paying the rent as tenants-at-will. For all practical purposes the two buildings were one, since doors were cut through the intervening wall on all floors. However, each building had a separate heating and plumbing system.

During the course of the annual audit in early 1937, the auditors discovered that an amount of $91.20 a month had been charged to the insurance expense account on the books of the parent company. Upon further inquiry and investigation the following additional facts were divulged:

1. During 1936 a fire alarm automatic sprinkler system had been installed in the buildings for which the parent company incurred the liability for the total cost, which was to be paid in monthly installments of $91.20 a month for 36 months from July 1, 1936.
2. The monthly payments, as and when paid, were charged to insurance expense, it was explained, because the installation of the sprinkler system had resulted in a saving in insurance premium expense of nearly $1,000 a year.
3. The liability to the sprinkler company was not reflected on the books.
4. The sprinkler pipes were erected in both buildings, as if they were one, but the controlling apparatus, which presumably represented a substantial portion of the total cost, had been installed in the basement of building *B*, which the corporation did not own.
5. The sprinkler apparatus as a whole had an estimated life of 15 years.

Draft a statement which you would present as the company's public accountant covering your recommendations on the setting up of the acquisition of this sprinkler system (1) upon the books, (2) upon the December 31, 1936, balance sheet, and (3) in the operating statement for the year ended December 31, 1936.

44. BARTLETT INDUSTRIES, INC.

FIXED ASSETS: HOW SHOULD APPRECIATION BE HANDLED?

Bartlett Industries, Inc., had its plant appraised in January, 1930, by the Universal Appraisal Corporation at the then replacement cost new, less estimated accrued depreciation. The resulting net appreciation over book value at cost was $692,701.29. This appreciation was entered upon the books of the company. Subsequently, the stockholders voted to issue from this revaluation surplus 1,200 shares of $100 par preferred stock, which were to be ratably distributed to the common stockholders.

Depreciation was calculated upon the amount of the appreciation only to December 31, 1932, and amounted to $156,788.32. The appreciation on plant properties abandoned in 1933 amounted to $196,921.78, against which depreciation of $32,121.36 had been provided.

The cost of the plant properties abandoned was written down to a nominal figure of $5,000. The cost of the plant remaining in operation as at December 31, 1936, was $422,386.69, against which a depreciation reserve of $180,391.20 had been provided.

Prepare the December 31, 1936, balance sheet items for the plant properties and the surplus arising from the revaluation, using the captions and figures which you would be willing to certify as the company's public accountant.

45. HOPKINS DEPARTMENT STORE—PART VI

FIXED ASSETS: WHAT VERIFICATION OF THE FIXED ASSETS OF THE HOPKINS DEPARTMENT STORE SHOULD THE AUDITOR MAKE?

On the balance sheet as of December 31, 1926, of the Hopkins Department Store, the main divisions under the general caption

Fixed Assets were Land, Buildings, Equipment, Fixtures, and Automobiles.

The company owned the store building which it occupied and a warehouse nearby. The book value of the land had remained at the same figure on the ledger for several years and was recorded as follows:

Store Building Land	$48,000
Warehouse Land	10,400
Total Book Value of Land	$58,400

On the building account at December 31, 1926, the store building was valued at $310,432.90 and the warehouse at $56,070.15. It was learned from the manager that an addition to the warehouse was built in 1927. The following entries covering its cost were found in the journal:

December 12, 1927—C. H. Shane—Material	$145.90
December 12, 1927—C. H. Shane—Labor	428.20
Total Expenditure for Addition	$574.10

In the opinion of the auditors this constituted a proper capital charge, and vouchers supporting the entries were seen.

The figure for Equipment at December 31, 1926, was distributable in the amount of $36,430.56 to Store Equipment, and $12,794.25 to Warehouse Equipment. All the entries in the general journal which applied to the additions to equipment were found as given below:

Date	Distrib.	Invoice No.	Firms	Amount
Feb. 13	Store	C—769	C. S. Warren	$236.68
Mar. 6	Warehouse	C—947	A. B. Black	135.76
May 7	Store	C—1238	A. P. Little	596.28
May 19	Store	C—1469	P. R. Croup	373.69
Aug. 21	Warehouse	C—2514	A. M. Smith	117.31
Sept. 30	Store	C—3009	F. E. Tolke	625.27
Nov. 25	Warehouse	C—3603	J. B. Flock	86.94

Examination of the general ledger revealed that the items[1] listed (page 312) had been charged to the Fixtures Account during the year. Vouchers supporting these entries were examined and

[1] The original items have been condensed in this problem for the sake of simplicity.

found to be in order, and in the opinion of the auditors all the items were properly charged.

Date	Dept.	Invoice No.	Firm or Agent	Amount
Jan. 7	General	C—231	S. A. Brown	$199.68
" 13	9	C—337	M. R. Morton	123.98
" 19	7	C—394	P. B. Smith	49.62
" 29	2	C—454	R. E. Green	33.81
Feb. 3	8	C—691	J. A. Hays	154.66
" 6	3	C—702	F. C. Covert	29.01
March 17	8	C—1171	A. K. Morrison	141.11
" 23	10	C—1221	P. B. Smith	55.77
May 15	1	C—1376	J. A. Hays	25.47
" 22	9	C—1497	S. A. Brown	232.36
" 27	5	C—1527	A. K. Morrison	26.68
June 3	General	C—1588	R. K. Jones	173.81
" 5	General	C—1602	M. R. Morton	229.82
" 11	8	C—1637	F. B. Black	176.22
" 27	5	C—1761	F. C. Covert	23.23
" 29	8	C—1779	J. A. Hays	312.53
July 7	6	C—1831	P. B. Smith	21.32
" 11	General	C—1857	A. K. Morrison	296.95
" 13	3	C—1877	M. Y. Mason	23.71
" 21	4	C—1923	E. S. Robert	31.63
" 24	9	C—1972	B. T. Hammond	99.59
" 30	8	C—2117	A. R. Foster	160.07
Aug. 5	10	C—2302	S. A. Brown	41.07
" 8	General	C—2322	A. K. Morrison	145.83
" 17	9	C—2471	P. B. Smith	157.91
Sept. 3	General	C—2604	R. E. Green	183.29
" 7	1	C—2656	E. S. Robert	22.45
" 12	8	C—2739	M. Y. Mason	106.07
" 22	3	C—2872	J. M. Jones	22.34
" 26	5	C—2912	P. B. Smith	22.02
Oct. 3	2	C—3018	S. A. Brown	40.11
" 7	General	C—3088	F. E. White	299.51
" 12	4	C—3132	M. R. Morton	25.11
" 14	8	C—3147	J. A. Hays	216.88
" 23	9	C—3225	F. B. Black	98.87
" 25	8	C—3270	F. C. Covert	84.78
Nov. 4	10	C—3343	A. K. Morrison	66.56
" 7	3	C—3391	A. R. Foster	45.77
" 12	General	C—3426	E. S. Robert	214.16
" 18	9	C—3496	J. M. Jones	151.51
" 21	5	C—3528	F. E. White	7.54
" 24	8	C—3592	F. B. Black	85.88
" 30	7	C—3625	A. K. Morrison	81.88
Dec. 2	9	C—3682	S. A. Brown	243.88
" 5	3	C—3721	R. E. Green	23.14
" 11	General	C—3796	J. A. Hays	333.36
" 12	8	C—3810	P. B. Smith	37.33
" 18	2	C—3877	E. S. Robert	31.49
" 28	9	C—3925	A. R. Foster	239.07

The Fixtures Account showed the following distribution on the ledger as of December 31, 1926:

Distribution	*Amount*
General fixtures	$21,241.54
Dept. 1	2,965.56
" 2	12,274.24
" 3	4,840.50
" 4	13,316.22
" 5	3,117.92
" 6	2,391.02
" 7	70.16
" 8	3,956.64
" 9	6,418.37
" 10	6,754.37
	$77,346.54

Scrutiny of the expense register revealed several items charged to Repairs and Maintenance which were really capital charges and should have been charged to the Fixtures Account. They were as follows:

Date	Dept.	Invoice No.	Firm or Agent	Amount
March 30	General	C—1270	J. M. Jones	$170.95
August 2	3	C—2281	P. J. Smith	24.19
Sept. 7	8	C—2650	F. E. White	119.25

The Automobile Account on December 31, 1926, showed a balance of $3,856.28 before depreciation. On March 13, 1927, a new Green delivery car was purchased for $873.04. An allowance of $120, which was obtained on a Red delivery car turned in, was applied against the price of this new car; painting and lettering for the new car cost $30. Vouchers covering these expenditures were seen and were in good order. Accrued depreciation on the Red delivery car as of the first of the year had amounted to $792.50. The difference between the net book value and the trade-in value, or $90.50, had been charged to depreciation expense for 1927.

Depreciation was charged by the store at the following rates which were deemed adequate by the auditors:

Buildings	2% annually
Equipment	4% "
Fixtures	10% "
Automobiles	25% "

Additions during the year were depreciated at half the annual rate.

Discuss critically the work done in this part of the audit. Prepare any schedules and adjustments required. Was further verification necessary?

CHAPTER IX

AUDIT OF OTHER ASSETS

46. NORTHERN STATES POWER COMPANY

BOND DISCOUNT: HOW SHOULD UNAMORTIZED BOND DISCOUNT BE HANDLED IN REFUNDING ISSUES?

In a prospectus dated February 11, 1937, appeared the following comment on the balance of unamortized debt discount and expense of $7,186,948, appearing on the balance sheet at October 31, 1936:

> The balance (including $2,804,274.53 discount, premiums and expense applicable to refunded issues) is in process of amortization over the lives of issues outstanding at October 31, 1936, on a straight-line basis. The company proposes to amortize over the life of the new bonds the discount, if any, and expense on the new bonds and the unexpired discount and expense, redemption premium and duplicate interest on that part of the bonds proposed to be retired which will be retired by the proceeds of the new bonds, and to amortize the unexpired discount and expense, redemption premium and duplicate interest on that part of the bonds proposed to be retired which will be retired by the proceeds of the new preferred stock, over the life of the respective bonds to be so retired.

The following accounting release of the Securities and Exchange Commission appeared on December 23, 1938:

ACCOUNTING SERIES
Release No. 10

The Securities and Exchange Commission today made public an opinion in its accounting series as to the proper treatment of unamortized bond discount and expense applicable to bonds which, prior to maturity, have been retired out of the proceeds of a sale of capital. The opinion, prepared by William W. Werntz, Chief Accountant, follows:

"Question has frequently been raised as to the proper treatment to be accorded unamortized debt discount and expense applicable to bonds which, prior to maturity, have been retired by the use of funds derived from the sale of capital stock. As generally presented, the inquiry relates to the propriety of carrying such unamortized debt

discount and expense as a deferred charge and amortizing it over the remaining portion of the original life of the retired bonds.

"While it may be permissible to retain on the books and amortize any balance of discount and expense applicable to bonds refunded by other evidences of indebtedness, similar treatment is not ordinarily acceptable, in my opinion, when funds used to retire the existing bonds are derived from the sale of capital stock. In such cases it is my opinion that, as a general rule, sound and generally accepted accounting principles and practice require that the unamortized balance of the debt discount and expense applicable to the retired bonds should be written off by a charge to earnings or earned surplus, as appropriate, in the accounting period within which the bonds were retired."

Compare these two statements. What is your opinion as to how unamortized discount in refunding issues should be handled?

47. LAPHAM INDUSTRIES, INC.

DEVELOPMENT ACCOUNT: WHEN SHOULD DEVELOPMENTAL EXPENDITURES BE CAPITALIZED?

Since 1909, Lapham Industries, Inc., had been a successful manufacturer of household appliances. Following 1926 major emphasis was placed upon the manufacture of a line of low-priced radios and electrical household equipment.

The company had done considerable research in the development of a refrigerator which would greatly diminish operating costs for domestic refrigeration and numerous tests had convinced the executives that the new refrigerating unit was sound and promising of commercial success. Although it was not planned to drop the lines which had formerly proved profitable, it was anticipated that sales of refrigerating units would be of increasing importance.

Beginning in 1928 operations were unprofitable and in June, 1930, at the request of creditors the company engaged a firm of public accountants to make an audit of its accounts.

Lapham Industries, Inc.
Balance Sheet, June 30, 1930

Current Assets:			
Cash		$ 83,461.55	
Trade Accounts Receivable	$124,676.81		
Less: Reserve for Bad Debts	29,000.00	95,676.81	
Contracts Unbilled		71,850.00	
Inventories:			
Finished Stock	$301,246.75		
Raw Materials and Work in Process	312,897.15		
Supplies	27,381.90	641,525.80	
Total Current Assets			$ 892,514.16
Fixed Assets:			
Land		$1,173,467.41	
Buildings, Machinery, Equipment, etc.		1,684,325.79	
		$2,857,793.20	
Less: Reserve for Depreciation		407,601.44	2,450,191.76
Other Assets:			
Associated Company Advances		$ 34,293.21	
Advances to Officers and Employees		38,194.26	
Notes Receivable		4,007.50	
Total Other Assets			76,494.97
Deferred Charges:			
Prepaid Insurance		$ 7,310.75	
Prepaid Interest		1,676.48	
Deferred Mortgage Expense		13,353.79	
Total Deferred Charges			22,341.02
Goodwill			1.00
Refrigerating Development			664,724.19
Total Assets			$4,106,267.10

LAPHAM INDUSTRIES, INC. (*Continued*)
BALANCE SHEET, JUNE 30, 1930

Current Liabilities:		
Notes Payable Banks	$ 165,000.00	
Trade Acceptances Payable	9,832.35	
Accounts Payable	47,805.67	
Accrued Interest and Taxes	21,101.64	
Total Current Liabilities		$ 243,739.66
Other Liabilities:		
Notes Payable in 1932	$ 655,000.00	
Mortgages Payable*	315,196.00	
Total Other Liabilities		970,196.00
Total Liabilities		$1,213,935.66
Reserves:		
For Contingencies	$ 225,000.00	
For Taxes	49,137.64	
Total Reserves		274,137.64
Capital Stock and Surplus:		
6% Cumulative Convertible Participating Preference Stock of $20 Par Value, Authorized 150,000 Shares, Outstanding 60,000 Shares	$1,200,000.00	
Common Stock—No Par Value Issued and Outstanding	806,075.00	
Total Capital Stock	$2,006,075.00	
Surplus	612,118.80	
Total Capital and Surplus		$2,618,193.80
Total Liabilities		$4,106,267.10

* Payable, $250,000 in April, 1932, and $65,196 in May, 1934.

ANALYSIS OF SURPLUS

Earned Surplus:				
Balance December 31, 1929				$ 517.29
Less: Organization Expenses Written Off			$ 63,125.00	
Net Loss for 6 months ended June 30, 1930			401,722.40	464,847.40
Profit and Loss Deficit June 30, 1930				$ 464,330.11
Add: Capital Surplus				
To transfer to surplus the excess over $5 per share of common stock in accordance with Certificate of Amendment dated January 17, 1930			$1,288,001.45	
Amount above $5 per share received on stock sold January 17, 1930			61,913.45	
To restore mortgage expense previously written off and now to be applied against future years' earnings			21,604.17	
Total Additions			$1,371,519.07	
Less: Depreciation on Appreciation of Buildings, Machinery, etc.		$ 14,123.41		
Dividends Paid				
Preferred				
Cash	$36,000.00			
Stock	6,000.00			
	$42,000.00			
Common				
Stock	13,946.75			
Total Dividends		55,946.75		
Reserve for Contingencies		225,000.00	295,070.16	
Net Capital Surplus				1,076,448.91
Surplus as per Balance Sheet June 30, 1930				$ 612,118.80

The company's unaudited balance sheet and reconciliation of surplus as of June 30, 1930, were as shown on the preceding pages.

The senior accountant in charge of the audit asked one of his assistants to prepare an analysis of the account listed in the balance sheet as Refrigerating Development. The assistant submitted the following analysis:

REFRIGERATING DEVELOPMENT

Valuation placed upon Refrigerating Process when the stock of this company was issued in exchange for that of the three subsidiary companies		$400,000.00
Expenditures to June 30, 1929:		
Process Department Research	$39,000.00	
Patents	6,000.00	
Sales Equipment	31,109.65	
Patterns and Drawings	5,500.00	81,609.65
Expenditures July 1 to December 31, 1929:		
Process Department Research	$58,106.50	
Special Research and Development	30,996.18	
Patents	29.17	
Miscellaneous Expenditure on New Lines	14,879.95	104,011.80
Expenditures January 1 to June 30, 1930:		
Regular Research and Development	$10,076.50	
Process Department Research	34,914.12	44,990.62
Management Salaries:		
Arthur Paine	$ 4,800.00	
William Clark	2,950.00	7,750.00
Office Salaries:		
Jerome Lapham (April, May, June at $900 a month)		2,700.00
Traveling Expenses		2,596.84
Patents:		
E. Somerset } Professional Services	$ 775.00	
C. E. Oldman }	1,125.00	1,900.00
Development and Miscellaneous:		
R. Morley	$ 500.00	
Insurance (Compensation and Fire)	513.94	
Drawing Boards	32.00	
Dues—Trade Association	425.00	
Gratuities (Arthur Paine)	390.00	
Tests	1,427.00	
Special Metal	335.50	
Removing Rubbish	110.00	
Lumber and Miscellaneous Expenses	4,945.65	
		8,679.09
Labor and Wages:		
Labor (Research and Tests)	$ 5,123.54	
Repairs to Furnace	336.50	
Wages (Sample Refrigerators)	5,026.15	10,486.19
Total—June 30, 1930		$664,724.19

What further analysis would you make before certifying the Refrigerating Development Account?

48. SECURITIES AND EXCHANGE COMMISSION—NO. 1

PATENTS: SHOULD FULLY AMORTIZED PATENTS BE SHOWN ON THE BALANCE SHEET?

In an address delivered before the Milwaukee Chapter of the Wisconsin Society of Certified Public Accountants on January 8, 1937, Mr. George C. Mathews, Commissioner, Securities and Exchange Commission, discussed "a few of the specific problems which have arisen in the administration of the Securities Act . . . " He referred to one case in which the registrant's balance sheet included approximately \$302,000 for patents, from which was deducted a reserve for amortization of some \$296,000, leaving a balance of about \$6,000. The following footnote appeared relative to intangible assets:

> There is included in the above reserve for amortization of patents \$294,816.37 applicable to patents covering chain manufacture which were fully amortized prior to June 30, 1932.

A substantial part of these patents had expired and the Commission questioned the propriety of showing them in the balance sheet. The registrant objected to amending the financial statements.

What were the probable arguments of (*a*) the Commission and (*b*) the company management in this controversy?

As a public accountant engaged to audit the books of this company, what alternative methods for treating this matter occur to you and what treatment would you advise?

49. INCA OIL AND GAS COMPANY

VALUATION OF LEASES: WHAT FACTORS AFFECT THE VALUATION OF LEASES FOR BALANCE SHEET PURPOSES?

During 1928 the Inca Oil and Gas Company, operating in the state of Texas, had purchased several leases on undeveloped oil properties throughout the state at bargain prices. These leases had been largely acquired on "wildcat" lands by agents in the employ of the company who were known as scouts or "lease-

Inca Oil and Gas Company "Leases" Account

Date	Explanation	Amount	Date	Explanation	Amount
January 1, 1928	Balance	$366,023.15	September 6, 1928	Abandonment of Old Wells	$ 66,013.63
March 6	Cash Bonuses on Leases #614	15,000.00	October 8	Amortization of Dry Holes	42,501.92
March 14	" " " " #615	20,000.00	December 3	Amortization of Leases	93,722.07
March 22	" " " " #616	12,000.00	December 7	Sale of Old Lease #591	88,808.60
April 4	" " " " #617	5,500.00	December 20	Cancelled Lease	14,653.22
April 6	" " " " #618	3,700.00	December 31	Balance	583,591.80
April 29	" " " " #619	4,500.00			
May 20	" " " " #620	6,200.00			
June 3	" " " " #623	22,000.00			
August 10	Development Costs #614–#619	86,349.12			
August 28	" " #620, #623	31,505.03			
September 1	Commissions	12,650.00			
September 20	Cash for Options	2,500.00			
October 19	Appreciation of Leases	167,419.56			
November 11	Recovered or Reclaimed Lease	37,112.75			
December 17	Royalties on Developed Leases #615, #616, #623	71,431.63			
December 29	Rental Charges on Leases #614, #617, #618, #619, #620	25,400.00			
		$889,291.24			$889,291.24
January 1, 1929	Balance	$583,591.80			

hounds." The terms of these leases provided for a portion of the cost to be paid by an original cash bonus, and the balance out of one-third of the first oil or gas produced under each respective lease. In addition a fixed annual rental was to be paid the owner of the property until wells were drilled and oil produced, after which a royalty of one-eighth of all oil produced thereon was to be paid, and the rental charge was to be discontinued. If development of the properties returned only "dry" leases, the company paid the balance of the lease cost in cash and charged the total cost to current operations. This latter procedure was believed to be both permissible and correct in view of the fact that the acquisition, exploration, and development of leased property are generally considered normal operating functions of oil companies.

Notwithstanding the highly speculative and problematical character of these acquisitions, the Inca Oil and Gas Company instituted a development program thereon in 1928 which resulted in large discoveries of oil on many of the leases. These discoveries naturally increased the value of these leases greatly over their cost to the company. After the development program had definitely established the existence of oil, the company "capped" the greater portion of the wells, awaiting a more favorable market for petroleum. Production, however, was maintained on a few leases.

At the end of 1928 the Inca Oil and Gas Company closed its books and employed a firm of accountants to make an audit of the accounts. In the course of their examination the auditors were presented with the transcipt of the ledger account "Leases" as shown on page 321.

In analyzing this account the auditors brought additional information to light regarding certain of the transactions.

(*a*) Legal and administrative expenses connected with abstracting and perfecting the title to lease #616 and amounting to $4,475 had been charged to current operations as "General Expense."

(*b*) During 1928, leases #621 and #622 had been purchased at a cost of $7,500 and $6,000 respectively but immediately after the purchase and before the transaction was recorded on the books, they had been subleased to another company, which paid the Inca Oil and Gas Company $20,000 and agreed that the latter should have a half interest in all oil produced but should at the same time pay all royalties due the owner. The net cash

gain, after the balance due the owner was paid him, was credited to "Miscellaneous Income." The auditors discovered that accrued royalties due the owner amounted to $2,965.01.

(*c*) Cash bonus payments for the new leases amounted to 75% of the total cost in each instance.

(*d*) Rental charges included in the account were only on undeveloped leases. Rentals during 1928 on developed but non-productive leases amounted to $17,400 and had been charged to "Operating Expenses."

(*e*) The "Recovered or Reclaimed Lease" item represented the appraised value of a lease which had been charged off in a previous year as dry but was later found to contain oil. The original cost of this lease, including development and rental, had amounted to $11,653.16. Prior to the appraisal additional expenditures amounting to $8,433.17 had been made in 1928 to bring the well to a producing stage. These expenditures had been charged to current operations.

(*f*) Excluding #621 and #622, which had been subleased, only leases #615, #616, and #623 were producing, all other wells having been "capped." Included in the item "Royalties on Developed Leases" were the balances paid in accordance with the original agreements, out of the first oil produced on these leases, and, in addition, the usual royalties of one-eighth of all oil produced.

(*g*) All options had been forfeited during the year.

(*h*) "Commissions" represented amounts paid to "lease-hounds" regularly employed by the company.

(*i*) As the result of an appraisal, the book value of leases acquired during 1928 had been written up $135,400.00; and, of old leases, $32,019.36. Of the amount charged to current operations for amortization of leases, $13,777.40 had been charged to amortize this appreciation.

(*j*) Lease #591 had been originally entered on the books at $107,707.13.

Prepare any adjusting entries you believe necessary.

50. WARD CORPORATION

MISCELLANEOUS ITEMS: WHAT PROCEDURE SHOULD BE FOLLOWED IN AUDITING MISCELLANEOUS ITEMS?

The accounts of the Ward Corporation, manufacturers of special machinery, had never been examined by independent auditors until November 30, 1927. In the course of their examination the auditors found that:

1. In 1919 the company had invested $1,000,000 in the purchase of 51% of the common stock of a company that had not paid dividends at any time from 1920 to 1927, inclusive.

2. The accounts receivable carried on the books at $850,000 included $200,000 of balances due under conditional sales contracts which provided for payments in three yearly installments. Of those balances, $30,000 were for unpaid installments that were due prior to August 31, 1927.

3. The inventory, which was valued by the company at $900,000, included $65,000 in parts for machines which the company had not manufactured since June 1, 1926.

4. Patent litigation had been pending for eight months. Counsel had rendered no bill for services to date and there was no liability on the company's books for legal services.

Discuss each situation briefly, stating any adjustments which should have been in the company's book figures before certification of the balance sheet as representing a true exhibit of financial condition.

51. R. C. BAIRD COMPANY

DEFERRED CHARGES: HOW SHOULD THEY APPEAR IN THE BALANCE SHEET AND OPERATING STATEMENT?

A public accountant had been engaged by the R. C. Baird Company, a manufacturing concern, to examine the accounts of the company as at the close of business December 31, 1933. The trial balance of accounts taken from the general ledger included an account entitled Deferred Expenses with a total debit balance of $122,000. Analysis of this account indicated that it included the following items:

1. Alterations to leased premises..........................	$ 5,685
Inquiries indicated that this covered improvements made to the company's New York sales office, and that the alterations were being amortized over the life of the company's lease.	
2. Prepaid insurance..	4,680
Calculations indicated that prepaid insurance at the end of 1933 had been accurately computed but that an unpaid insurance bill of $1,202 had been deducted in arriving at the foregoing balance ($4,680).	
Forward..	$ 10,365

Brought Forward	$ 10,365
3. Protest fees on unpaid checks	25
This item represented bank charges and notary public fees in connection with unpaid checks returned to the company because of insufficient funds, etc.	
4. Premium paid on bonds purchased	400
Inspection of brokers' advices indicated that the corporation had purchased $10,000 U. S. Treasury certificates as a temporary investment paying therefor $10,400. The certificates were selling at 105 at the end of 1933. The face amount had been included in the investment account and the premium paid is shown above.	
5. Inventory adjustments	1,944
The auditor was informed that it was the company's practice to verify certain inventory items from time to time during the year, and that the adjustments required to bring the book inventory into agreement with the physical quantity on hand were recorded in this account.	
6. Collections of accounts receivable previously written off	1,406*
Inquiry revealed that, for convenience, it was the practice of the company to segregate collections of such accounts under deferred expenses until the end of the year.	
7. Bond discount	50,000
This applied to the company's bonds and was being amortized over the life of the bonds.	
8. Inventory on consignment	14,100
Verification of this item with the consignees indicated that one-half of the total had been sold and that net proceeds of $8,000 were due from the consignee.	
9. Advance charges paid on consignments	440
Analysis indicated that this item included cartage and shipping charges on the foregoing inventory ($14,100) on consignment.	
10. Organization expense	21,402
Examination indicated that this item included the usual expenses for legal fees, stock certificates, and other expenses incurred in connection with the organization of the corporation.	
11. Cash in closed bank	10,000
The confirmation secured from the receiver of the closed bank indicated that, in his opinion, approximately 95% of the deposit would eventually be collected.	
12. Salaries paid in advance	450
As indicated, this item represented the salaries of J. L. Ames and R. R. Wright paid in advance. Examination showed that the total amount accrued for salaries as at December 31, 1933, was overstated on the books of account, in that it included the amount due Messrs. Ames and Wright.	
13. Interest paid on bank loan	1,240
Inspection of bank advices indicated that this interest was paid on the corporation's note discounted at the bank July 1, 1933, and maturing on September 30, 1933. The note was being continued by the bank as a demand loan, with interest payable monthly.	
Forward	$108,960

* Red.

Brought Forward	$108,960
14. Accounts receivable from officers	6,240
The auditor was informed that this item was included in deferred expenses because the treasurer of the concern did not wish to open a separate account on the books. He was also informed that the amount due represented temporary borrowings by certain of the officers and that the balance would be repaid within the next six months through deductions from salaries. He found that substantial amounts had been paid prior to December 31, 1933, and that the rate of payment would, if maintained, extinguish the debt prior to June 30, 1934.	
15. Fire loss	6,800
The auditor was informed that this represented loss on merchandise in connection with a fire at the company's branch warehouse, and his inquiries to the insurance company indicated that it was probable the entire amount would be allowed within the next three months.	
Total	$122,000

Audit the above account.

State exactly how you would have classified these items on the certified detailed balance sheet and profit and loss statement of the R. C. Baird Company.

52. PRATT PROCESSING COMPANY

PROCESSES AND FORMULAS: TO WHAT EXTENT SHOULD AN AUDITOR QUESTION THE OWNERSHIP OF ASSETS OF HIS CLIENT?

The Pratt Processing Company was organized in 1923 with authorized and issued capital stock of $100,000.00. During the years 1924, 1925, and 1926 the business, which was very profitable, owed a large part of its success to secret processes and formulas.

There had been no previous audit of its records when the company employed a firm of accountants to examine its accounts as of December 31, 1926. The auditors, who began their examination January 10, 1927, found the following account in the general ledger:

PROCESSES AND FORMULAS

Date	Description	Debit	Credit
4/26/23 J2	Stock issue	$25,000.00	

And on page 2 of the journal they found the following entry:

		Debit	Credit
4/26/23	Processes and Formulas To Capital Stock Capital stock issued to C. L. Joyce, president, for his secret processes and formulas.	$25,000.00	$25,000.00

On January 28, 1927, the auditors wrote a letter as follows:

Mr. C. L. Joyce, President,
Pratt Processing Company,
Springfield, Illinois.

Dear Sir:

We have completed the examination of your accounts as at December 31, 1926, except that we have not been able to determine the status of the processes and formulas account represented in the ledger at $25,000.00.

For your immediate purposes we enclose a tentative balance-sheet without our signature. We shall be prepared to issue a certified statement when evidence is available proving that the company is in possession of the secret processes and formulas, and that it is in a position to protect itself from their loss.

Very truly yours,
LYNCH, FAXON & CO.

Under what conditions would it become proper for the auditors to sign an unqualified certificate for this company's balance sheet as of December 31, 1926?

53. AXTON AND BELL

BOND DISCOUNT: HOW SHOULD DISCOUNT ON SERIAL BONDS BE AMORTIZED?

Axton and Bell, public accountants, had performed annual audits for the Glass and Holt Company for several years. In December, 1935, they were called in by the treasurer, Mr. Walter Glass, who stated that the company had issued $2,000,000 in 6% bonds on January 1, 1935. These bonds were sold at 96 to a local firm of investment bankers, who offered them to the public

at par. Interest was payable semiannually. Mr. Glass was preparing to close the books of the company for 1935, and he was in some doubt as to how to write off the discount on the bonds, of which $200,000 were to mature on January 1, 1937, $300,000 on January 1, 1938, $400,000 on January 1, 1939, $500,000 on January 1, 1940, and the balance on January 1, 1941.

Suggest reasonable methods for writing off the discount, defend the best one, and prepare a statement to be handed to Mr. Glass for his guidance in applying this method throughout the life of the bonds.

54. LITTLETON COMPANY

FIRE INSURANCE: WHAT IS THE RETURN UNDER A COINSURANCE CLAUSE?

While Jones and Smith, certified public accountants, were engaged in a detailed audit of the transactions of the first year of existence of the Littleton Company, they came upon several receipts of cash from fire insurance companies which they felt it was necessary to verify. Inquiry revealed that there had been five fire insurance policies carried upon a building whose sound value was set at $150,000, and which was destroyed by fire to the extent of $60,000. Each of the policies had a clause which stated that the insurance company would not be responsible for a larger fraction of any loss incurred than the face of the policy as compared with the total insurance carried on the property, whether or not it could be collected.

The companies, amounts of the policies, and the coinsurance clauses were as follows:

Insurance Company	Amount Insurance	Coinsurance Clauses
A	$ 5,000	None
B	10,000	100%
C	15,000	90%
D	20,000	80%
E	50,000	70%
	$100,000	

How much should the Littleton Company have received on each policy?

How much would the company have received on each policy if the sound value had been $100,000?

55. HOPKINS DEPARTMENT STORE—PART VII

DEFERRED ITEMS: TO WHAT EXTENT SHOULD THE DEFERRED ITEMS OF THE HOPKINS DEPARTMENT STORE BE AUDITED?

The Hopkins Department Store kept a record of its insurance policies in an Insurance Register, which had a separate page for

Kind of Insurance	Policy Number	Company	Face Amount	Total Premium	Term Years	Expires		
						Mo.	Day	Yr.
Rent Insurance	376893	Brown	$12,000	$ 57.60	5	6	4	31
Warehouse Bldg.	478417	Brown	23,000	276.00	5	12	1	29
	536711	Green	43,000	516.00	5	12	1	29
Forgery Bond	764891	Grey	3,750	57.37	3	11	30	30
Use and Occupancy	654321	White	72,000	332.13	3	8	20	29
	869432	Green	144,000	664.26	3	8	20	29
Burglary	764721	Grey	30,000	900.00	1	5	2	28
Sprinkler Leakage	76894	Brown	25,000	247.00	5	4	16	30
Store	75974	Brown	10,000	208.36	5	4	16	30
Sprinkler Leakage Storehouse	67512	Brown	6,000	280.32	5	3	6	30
Liability	479732	Blue	5,000	208.98	3	9	24	28
	876595	Grey	20,000	50.00	1	5	1	28
	976891	Blue	....	338.74	1	12	29	28
	124917	Grey	3,000	7.50	1	1	1	28
	479217	Grey	10,000	25.00	1	1	13	28
Automobiles	764132	Brown	....	80.93	1	1	1	28
	231769	Brown	....	19.34	1	2	20	28
Store Contents	769312	Brown	66,667	213.33	1	8	20	28
	479869	White	66,667	213.33	1	8	20	28
	416231	Blue	66,667	213.33	1	8	20	28
	761861	Grey	60,000	192.00	1	9	20	28

each kind of insurance carried. The table given above shows the columns in this book except that the right hand portion of each page contained 12 additional columns, one for each month of the year. The monthly share of each premium was figured in these columns and the monthly charge for insurance was obtained from the totals of these columns. Reductions and cancellations were recorded in red.

The table on page 329 gives information obtained from the Insurance Register.

All policies were investigated and checked; there was found to be ample insurance to cover the asset accounts, as well as surety bonds to cover the responsible members of the staff.

Riders attached to the following policies gave notification of reductions in premiums:

Policy Number	*Reduction Date*
478417	12–1–27
536711	12–1–27
654321	8–20–27
869432	8–20–27
76894	4–16–27
75974	4–16–27
67512	3–6–27

Premium reductions had been 25% of the annual rate in each case, and had been granted in the form of rebates from the companies.

In addition to the prepaid insurance already given, it was found that prepaid insurance on other outstanding policies amounted to $2,258.77.

A surety bond running for one year and dated December 27, 1927, was found. This bond bore an annual premium of $53.34, the whole amount having been paid and treated as insurance expense for 1927.

In the checking of the policies, the following notations were made: (1) Some policies had been left in the file after they had expired. (2) Others had been continued in force, after their original dates of expiration, by riders; but these riders had not been attached to the policies, nor had the dates of expiration been changed on the policies. (3) Other riders containing general provisions of the policies had been left unattached. (4) The continuation clause on some of the surety bonds had apparently been used, but there was nothing on the policies to confirm this.

Taxes Prepaid showed a balance of $5,643.30 in the general ledger on December 31, 1927. The tax bills for the year April 1, 1927–April 1, 1928, covered state and local taxes and were apportioned as follows:

Tax on personal estate	$ 63.90
Tax on real estate	11,222.70
Total taxes	$11,286.60

The tax bills and the vouchers for payment were seen and were apparently in good order.

There was no Interest Prepaid item, as Notes Payable were not discounted but were interest-bearing.

Should any further verification be made? Discuss critically the work done. Prepare necessary schedules and carry adjustments to working trial balance schedules.

CHAPTER X

AUDIT OF LIABILITIES AND CAPITAL STOCK

56. DURABLE SHOE COMPANY

NOTES PAYABLE: WHAT PROCEDURE SHOULD AN AUDITOR FOLLOW WHERE A BANK CONFIRMATION OF NOTES PAYABLE IS NOT IN ACCORD WITH THE BOOKS?

Munson and Edwards, public accountants, audited the accounts of the Durable Shoe Company as of May 31, 1927.

The books showed that on that date the company was indebted to the Prudential Trust Company on unsecured notes to the amount of $150,000. These notes had matured on October 1, 1924. Interest had not been paid thereon for a year previous to May 31, 1927, and the liability to the bank for the accrued interest of $9,000 was shown in a separate account.

In order to confirm the liability, Munson and Edwards requested the treasurer of the Durable Shoe Company to send the following letter to the trust company.

June 12, 1927.

To Prudential Trust Company,

Our auditors, Messrs. Munson and Edwards, are now making an audit of our accounts as of May 31, 1927, and they wish to confirm the amount of our indebtedness to you on that date.

Please send to them direct a statement of all our obligations to you as of the close of business on May 31, 1927, giving dates, maturity, interest rates, accrued interest and collateral held, if any.

We enclose a stamped and addressed envelope for your reply.

Very truly yours,
DURABLE SHOE COMPANY.

Munson and Edwards received the following answer from the bank.

June 13, 1927.

To Munson and Edwards,

As requested by the Durable Shoe Company we hereby certify that at the close of business, May 31, 1927, they were not liable to us either directly or contingently.

Very truly yours,
PRUDENTIAL TRUST COMPANY.

What would have been your procedure upon receipt of this letter from the bank if you had been the auditor?

57. STERMER COMPANY

ACCOUNTS PAYABLE: SHOULD ACCOUNTS PAYABLE BE CIRCULARIZED?

The Stermer Company of Grand Island, Nebraska, manufactured electrical equipment. The company made an effort to pay all outstanding accounts as of the end of the year before the preparation of the balance sheet. In recent years the company sent out a form letter to all creditors asking for confirmation of the accounts as of the closing date.

Bonds and Larson, public accountants, had conducted the annual audit of the books of the company for several years. During the course of the audit, accounts payable were not circularized. The auditors did, however, verify all the accounts with the customer's statement sent in response to the letter referred to above. An outline of the audit procedure for accounts payable was as follows:

1. A check was made to insure that all invoices near the end of the period under audit were entered on the records. This was accomplished by running over the company's invoice record for the first month of the fiscal year following and questioning all items bearing an earlier date.
2. Each item dated in the fiscal year following was checked to make sure it covered material actually received during the period under audit.
3. A careful verification was made of the itemized material in transit record prepared by the company's accountants.
4. A number of invoices received during the latter part of the period under audit were reviewed and checked against receiving slips to make sure that the records were in order.

Do you consider adequate the audit procedure for accounts payable followed by Bonds and Larson?

58. LOWE TRADING COMPANY

ACCOUNTS PAYABLE: WHAT POLICY SHOULD AN AUDITOR FOLLOW WHERE HE FINDS A BILL OWING HIM UNRECORDED ON HIS CLIENT'S BOOKS?

The accounts of the Lowe Trading Company were examined by a firm of certified public accountants as of March 31, 1926. The

balance sheet which the senior accountant laid before the head of the auditing firm upon completion of the examination showed total assets of approximately $26,000,000. In the final review of the balance sheet the head of the auditing firm discovered that the liabilities did not include a bill for $2,400.00 which the auditing firm had rendered to the Lowe Trading Company in January, 1926, for special services in redesigning the accounting methods in the company's warehouse. The bill had not been questioned by the client, but it had not been paid. It had been mailed to the president of the company who had since gone abroad on business.

What significance would you attach to the fact that the bill had not been recorded on the company's books?

59. PACIFIC SHIPBUILDING COMPANY

LIABILITIES AS DEDUCTIONS: SHOULD AN AUDITOR CERTIFY A STATEMENT IN WHICH CERTAIN LIABILITIES ARE DEDUCTED FROM ASSETS?

The plant assets of the Pacific Shipbuilding Company were represented in its balance sheet for June 30, 1919, as follows:

Plant assets:		
Reproduction value less depreciation as appraised at date of organization		$5,807,602
Special facilities—cost	$470,000	
Less: Advances by United States Government which are subject to repayment only to the extent that appraised value of the special facilities at conclusion of contracts may exceed $290,000	180,000	290,000
Cost of other additions since date of organization	$320,186	
Less: Mortgages on properties purchased	95,000	225,186
Total		$6,322,788

What was the significance of the two deductions from assets?

Would you approve of this form of stating liabilities as deductions from assets if you were called upon as an auditor to certify the balance sheet?

60. SUSQUEHANNA LIME COMPANY

BONDS: WHAT PROCEDURE SHOULD AN AUDITOR FOLLOW IN AUDITING BONDS?

On January 1, 1922, the Susquehanna Lime Company issued \$3,000,000 5½% first mortgage sinking fund gold bonds, maturing January 1, 1937. The bond indenture provided that \$125,000 face value of the bonds should be called on July 1 of each year beginning in 1923 and retained in a sinking fund. These bonds had been sold to the underwriting syndicate at 91½, and sold by the syndicate to the public at 98. The bond discount and \$110,000 of financing expenses had been set up as deferred charges, to be amortized at the rate of one-tenth each year.

A refinancing program of the company which was effected in February, 1928, provided for the issue of \$8,000,000 first mortgage 20-year 5% bonds, dated January 1, 1928. The old 5½% bonds were called for redemption on July 1, 1928, at 106. The new 5% bonds were sold to underwriters at 94 and were offered to the public at par. Legal and miscellaneous expenses connected with the issue of the new bonds amounted to \$145,000 and were borne by the company and the underwriters in the ratio of 65% and 35% respectively.

The bond indenture for the new issue contained the following covenant in regard to sinking fund provisions:

SINKING FUND

Section 3: The company covenants that so long as any of the bonds issued hereunder shall be outstanding it will pay to the Trustee on the first day of July in each year, beginning with the year 1929, as a Sinking Fund for the retirement of bonds, a sum in cash equal to 10% of the net earnings of the company for the preceding fiscal year as determined by a certified public accountant, after deducting all operating expenses of the business and all taxes of any and every kind paid or accrued during the year in question, and all other charges of any and every kind which in the opinion of said accountant should properly be made against income, excepting only that there shall not be deducted any depreciation and obsolescence, including any reserves therefor, interest on bank loans, discount on bonds, or cost of underwriting, or Federal Income and profits taxes based on income of any year.

Section 4: In reduction of or substitution for cash payments required to be made under Section 3 of this Article, the company may deliver bonds with all unmatured coupons attached to the Trustee for cancellation and such bonds shall be accepted by the Trustee and

credited against the current sinking fund requirement at the cost to the company of such bonds including the cost of any interest accrued thereon on the date acquired by the company, decreased by the amount of the interest accrued thereon on such date, all, as certified, by its treasurer or an assistant treasurer (but in no event, at an amount exceeding 105 per cent of the principal amount thereof, less any accrued interest included in such price). Any balance of the sinking fund payments required to be made under said Section 3 not provided for by the delivery of bonds as aforesaid shall be paid in cash.

In the course of the year 1928, the company purchased $100,000 face value of 5% bonds on the open market in anticipation of the 1929 sinking fund requirement. A summary of the broker's statements is as follows:

	$100,000 5% *Mortgage Bonds*
Bonds	$94,875.00
Accrued Interest	1,089.00
Commission	300.00
Total	$96,264.00

The company charged the accrued interest to Bond Interest Expense, and the bonds and commission to Sinking Fund Securities. In order to carry the bonds at par in this account, it was debited with $4,825.00; the offsetting credit was to Miscellaneous Income.

The profit and loss statement for 1928 is given below:

Net operating profit (after deducting depreciation of $434,841.23)		$2,240,576.96
Add:		
Discount on bonds acquired for sinking fund	$ 4,825.00	
Income from Real Estate Rentals	11,033.60	
Dividends received from subsidiaries	54,505.17	
Gains applicable to prior years	43,184.54	
Profit on Sale of Real Estate	21,361.15	134,909.46
		$2,375,486.42
Deduct:		
Machinery rendered obsolete by new state laws	$ 77,939.45	
Loss on bad debts in excess of reserve	193,077.19	
Interest on bank loans	85,675.46	
Loss on purchase commitments	106,356.63	463,048.73
Net profit available for sinking fund requirements, bond interest, income taxes, amortization of bond discount and expense		$1,912,437.69

Draft journal entries to record the retirement of the $5\frac{1}{2}\%$ bonds in 1928 and the issue of the 5% bonds.

Compute the amount of cash needed to make the required payment to the sinking fund trustee on July 1, 1929. Show the reasoning by which you arrived at that figure.

61. NILES CHEMICAL COMPANY

SINKING FUND: HOW SHOULD A SCHEDULE FOR SINKING FUND PAYMENTS BE PREPARED?

The Niles Chemical Company floated a $2,000,000 bond issue on January 1, 1934, which it desired to retire at the end of 25 years by the creation of a sinking fund earning 5% per annum. No

Periods	Amount of $1 Compounded at 5%	Amount of Annuity of $1 Compounded at 5%
4	$1.2155	$ 4.3101
5	1.2763	5.5256
6	1.3401	6.8019
7	1.4071	8.1420
8	1.4775	9.5491
9	1.5513	11.0266
10	1.6289	12.5779
11	1.7103	14.2068
12	1.7959	15.9171
13	1.8856	17.7130
14	1.9799	19.5986
15	2.0789	21.5786
16	2.1829	23.6575
17	2.2920	25.8404
18	2.4066	28.1324
19	2.5270	30.5390
20	2.6533	33.0659

payments were to be made to the sinking fund until the end of the sixth year or December 31, 1939. Thereafter annual payments were to be made to the sinking fund at the end of each year. The first five payments were to be of the same amount; the next seven were to be 50% more than those of the first five years and for the remainder of the time they were to be double those of the first five years.

Prepare a schedule showing the annual payments to be made to the sinking fund.

62. VALERO SHELLAC COMPANY

CAPITAL STOCK: WHAT EXAMINATION SHOULD THE AUDITOR MAKE OF CHANGES IN CAPITAL STOCK IN THE PERIOD UNDER AUDIT?

On June 30, 1928, the balance sheet of the Valero Shellac Company contained the following statement of the company's capital accounts:

7% Preferred Stock, $100 par	$1,795,000.00
Common Stockholders' Equity—represented by 100,000 shares of no-par value, issued and outstanding	3,509,899.95

On June 30, 1929, the company's balance sheet reported the common stock equity as $4,823,154.12 which consisted of "Common Stock—$3,503,757.32" and "Surplus, $1,319,396.80." Transactions for the year affecting the statement of proprietary interest were:

(*a*) Sale of 25,000 additional common shares to the public at $40 per share which were taken into the stock account at $35 a share, on February 11, 1929.

(*b*) Appraisal of fixed assets $145,659.34.

(*c*) Profits from operations of Valero Shellac Company, $400,554.84; profits of a wholly owned subsidiary, $86,400.34.

(*d*) Purchase and retirement of 1,172 shares preferred stock for $112,162.04.

(*e*) Reserve for liability insurance of $18,609.39 restored to surplus.

(*f*) Payment of additional Federal income taxes in excess of reserve for years prior to June 30, 1928, $1,035.88.

(*g*) Dividends of $118,013 and $223,958.81 paid on the preferred and common stocks respectively.

From the above information prepare a schedule or schedules reconstructing the common stock equity as you think it should have appeared on the 1928 and 1929 balance sheets.

Discuss your treatment of any debatable points.

63. LEWIS FABRICATING CORPORATION

CAPITAL STOCK: WHAT SHOULD BE THE AUDIT PROCEDURE WHERE NO PAR STOCK IS ISSUED FOR PAR VALUE STOCK?

The capital stock and surplus of the Lewis Fabricating Corporation on December 31, 1925, was:

10,000 shares common stock of aggregate par value of	$1,000,000
Surplus (approximately)	500,000

Early in 1926 the stockholders voted to authorize the issuance and sale of 5,000 shares of 7% preferred stock, having an aggregate par value of $500,000 to bankers, who were to receive a commission of $30,000 for underwriting the issue. The stockholders also voted to authorize the issuance of 20,000 shares of common stock without par value which were to be exchanged for outstanding par value stock, in the ratio of two shares of the new for each old share outstanding.

These changes were effected and the par value shares of common stock were properly canceled. The bankers' circular for the offering of the preferred stock contained a balance sheet of the company as of December 31, 1925, giving effect to the recapitalization. The capital accounts appeared as follows therein:

Preferred stock	$ 500,000
Common stock without par value (20,000 shares)	1,000,000
Surplus	470,000

Was the capital properly stated in this balance sheet, in your opinion?

Would you, as an auditor, be willing to certify the balance sheet with the above information?

64. MOTOR ACCESSORIES CORPORATION

CAPITAL STOCK: HOW WOULD YOU PRESENT THE CAPITAL STOCK OF A HOLDING COMPANY?

The Motor Accessories Corporation was a holding company which owned a majority of the stock in companies manufacturing sundry automobile accessories such as bumpers, shock absorbers, wind-shield wipers, moto-meters, spotlights, etc. From time to time additional companies were acquired by an exchange of stock of the Motor Accessories Corporation for outstanding stock of these concerns. On March 31, 1927, the Motor Accessories Corporation had an authorized and issued capital of 400,000 shares of common stock without par value. These shares were carried on

the books at $18,500,000, but the market value of the stock on April 25, 1927, was $82 per share.

On April 25, 1927, the Motor Accessories Corporation offered to purchase the outstanding common stock of the Simplex Company by giving three shares of Motor Accessories Corporation stock for every share of common stock of the Simplex Company. This offer was accepted by the stockholders of the Simplex Company and in order to make the purchase the Motor Accessories Corporation increased the number of its authorized shares from 400,000 to 500,000. Under the terms of the offer all the common stock of the Simplex Company, 30,000 shares, was acquired. Expenses incurred in connection with this transaction included lawyer's fees, underwriter's commission, and stamp taxes amounting to $275,000.

At the time of purchase, the net assets of the Simplex Company were represented on its books at $7,102,623. In addition to its common stock, the Simplex Company had $2,000,000 par value of preferred stock outstanding which was callable as a whole, but not in part, at $107 per share.

In effecting the exchange of stock, the Motor Accessories Corporation debited its investment account $5,102,624 for the 30,000 shares of Simplex Company common stock and carried a like amount to its capital account for the shares issued in acquisition of the Simplex Company stock. A consolidated balance sheet was subsequently published by the holding company which showed among the assets:

Goodwill, acquired from Simplex Company.......................... $1.00

As an auditor, have you any criticism to make regarding the goodwill item presented in the consolidated balance sheet?

65. SUPERIOR STEEL CORPORATION[1]

CAPITAL STOCK AND SURPLUS: SHOULD RETROACTIVE ADJUSTMENTS BE MADE?

On or about December 31, 1916, 30 shares of Common Stock of the Corporation were issued for $3,000 in cash. On or about December 22,

[1] N. Y. Stock Exchange Listing Application, A-11,210, March 2, 1939.

1916, 35,000 shares of First Preferred Stock of the Corporation, 20,000 shares of its Second Preferred Stock and 59,970 shares of its Common Stock were issued, and the additional amount of $3,000 in cash was paid, for the properties and assets of Superior Steel Company, a Pennsylvania corporation. The property and assets thus acquired were recorded on the books of the Corporation at $4,250,514.70, which was their book value upon the books of the predecessor company and in which value fixed assets of $1,988,250.39 were included at historical cost less accrued depreciation. As this value was less than the aggregate claims of the First and Second Preferred Stocks upon such assets, no portion of the assets received remained to be allocated and set up as capital against the 59,970 shares of Common Stock.

Thereafter, from time to time, the Corporation sold 55,000 shares of Common Stock for a total cash consideration of $1,800,000, making the total consideration received for the Corporation's Common Stock, $1,803,000.

Under the provisions of its charter, the Corporation was required to create a reserve for the retirement of the First and Second Preferred Stocks issued in 1916. Such reserve was created out of earnings of the Corporation over the period from 1916 to 1924. As the Preferred Stocks were redeemed, payment therefor was made out of cash, the Preferred Stock account and the cash account both being reduced, and amounts equal to the cash thus used for redemption of the Preferred Stocks were thereupon transferred from the reserve to the common capital stock account, the total of such transfers amounting to $2,229,881.56. Inasmuch as the Preferred Stocks were retired out of earnings it would have been proper, after the Preferred Stocks were retired, to return the reserve to earned surplus instead of increasing the common capital stock account.

The common capital stock account was improperly credited also with $721,341.50 of capital surplus items, making a total of $2,951,223.06 of improper credits to common capital stock account.

As a result of these improper credits, the common capital stock account has been carried in previous balance sheets at $4,754,223.06. The present capital stock of the Corporation consists entirely of Common Stock. On the advice of the Corporation's attorneys and its independent accountants, the common capital stock account has been corrected, in conformity with Virginia Law,[1] and stated at the amount of the consideration received therefor, $1,803,000, which was cash.

[1] The law referred to is evidently that given below in condensed form:

" . . . The capital of a corporation shall be the sum of the consideration received by the corporation in payment for its shares of stock, whether with or without nominal or par value, plus such amounts as from time to time by resolution of the board of directors may be transferred to capital and/or less such amounts as may be transferred from capital by a reduction thereof, . . . and shall not include contributed surplus when, under the terms and conditions of the subscription agreement to any shares of stock, it is provided that in addition to the consideration paid for such stock, there shall be paid by the subscriber a sum to be contributed surplus of the corporation. . . . " (Virginia Code, §3840 as amended by L. 1932, p. 132.)

The difference of $2,951,223.06 has been restored to surplus. Capital stock in the treasury has been restated at average issued value, resulting in a charge of $44,242.68 against surplus.

Goodwill in the amount of $2,500,000 was recorded on the books of the Corporation as of the beginning of business in 1916. In 1924, the amount of the goodwill account was transferred to an account titled Plant Appreciation. At its meeting on December 10, 1938, the Board of Directors authorized the reversal of the entry of 1924 recording plant appreciation, thereby eliminating such appreciation from the books and reinstating goodwill. In accordance with further action of the Board of Directors taken at said meeting, the goodwill thus reinstated was charged off against the surplus arising from the correction of the capital stock account as described above. The net effect of the above adjustments of capital stock and the writing-off of goodwill is a reduction of the deficit to the extent of $406,980.38.

As a result of the adjustments described above, the net worth section of the balance sheet at December 31, 1937, appeared as follows:

Shareholders' equity:	
Capital stock—par value $100 per share; issued under the laws of the Commonwealth of Virginia, which permit the issuance of common capital stock at less than par value:	
Authorized, 115,000 shares, issued 115,000 shares	$1,803,000.00
Less capital stock in treasury, 1,724 shares at average issued value	27,029.32
Remainder—Outstanding 113,276 shares	$1,775,970.68
Deficit	33,413.98
Shareholders' equity—Net	$1,742,556.70

The statement of surplus (deficit) for the year ended December 31, 1937, is given below:

Balance at December 31, 1936	$ (710,066.94)
Adjustments:	
To restate the capital stock at the amount of consideration received therefor, $1,803,000	2,951,223.06
To write off goodwill	(2,500,000.00)
To restate the carrying value of capital stock in the treasury	(14,279.87)
Adjusted balance at beginning of period	$ (273,123.75)
Net income from statement of income	239,524.77
Discount on purchase of own bonds during the year	185.00
Balance at end of period	$ (33,413.98)

Parentheses denote red figures.

In your opinion were the accountants and lawyers justified in requiring the retroactive adjustments in this case? Give reasons.

66. HOPKINS DEPARTMENT STORE—PART VIII

NOTES AND ACCOUNTS PAYABLE: HOW SHOULD AN AUDITOR VERIFY THE NOTES AND ACCOUNTS PAYABLE OF THE HOPKINS DEPARTMENT STORE?

Notes Payable

The general ledger of the Hopkins Department Store showed a balance of $10,000 on the Notes Payable Account on December 31, 1927. The certificate received from the New Rochelle Commerce and Trust Company stated that the bank held four $2,500 notes of the Hopkins Department Store, made for 90 days each, and bearing 5½% interest. The expiration dates for the notes were respectively, January 15, January 31, February 20, and March 7. No other notes were reported.

Accounts Payable

Accounts payable were recorded in two voucher registers—a merchandise register and an expense register. A separate section for each department was provided in the registers and invoices were entered by departments on individual lines. The line and section in the register in which an invoice was entered were marked on the invoice, and when, as it frequently happened, an invoice applied to several departments, the departmental charges and the various lines and sections in the register were also indicated on the invoice.

Vouchers were serially numbered and the numbers entered in the register. Spaces were also provided for date of payment and check number. The vouchers were filed alphabetically in six files having the following limits:

1. A-C	4. M-O
2. D-F	5. P-S
3. G-L	6. T-Z

Within the files the vouchers were arranged chronologically with respect to dates of entry in the voucher registers. The book figures for accounts payable were: Merchandise, $53,096.07, and Expense, $2,651.95.

A search was made for invoices entered in the register after December 31, 1927, but applying to the period under review. The examination yielded the following information:

File	Date of Invoice	Voucher No.*	Dept.	Amount	Date Goods Received	Remarks
	1927					
A-C	12/29	1 – 5	9	$ 45.73	1/6	
	12/29	1 –19	9	15.66	1/6	
	12/28	1 –12	6	14.92	12/31	Not in Inventory†
	12/27	1 –31	6	3.33	12/30	Not in Inventory†
D-F	12/29	1 – 9	4	8.15	1/3	
	12/22	1 –40	3	12.00	1/4	
	12/29	1 –63	2	64.15	12/31	Not in Inventory†
	12/31	1 –18	{11	22.13‡}	1/4	
			7	17.55		
	12/30	1 –52	1	24.36	12/31	Not in Inventory
G-L	12/27	1 –25	{3	15.75}	12/29	Not in Inventory
			4	5.18		
M-C	12/29	1 –[illegible]	5	40.04	1/7	
	[illegible]/28	1 –17	11	8.77‡	12/31	Not in Inventory
	12/17	1 –44	1	35.11	1/5	
P-S	12/23	1 –32	8	6.55	1/5	
	12/28	1 –66	7	26.52	12/30	Not in Inventory
	12/27	1 –27	2	5.04	1/11	
	12/13	1 –36	{4	10.00}	12/30	Not in Inventory
			2	10.00		
T-O	12/30	1 –48	2	8.61	12/30	Not in Inventory
	12/23	1 –57	6	32.20	1/7	
	12/29	1 –34	7	136.17	12/30	Not in Inventory
	12/23	1 –91	8	1.76	12/27	Not in Inventory
	12/21	1 –60	9	88.00	1/12	
	12/22	1 –24	10	120.00	12/30	Not in Inventory
	11/14	2 –101	9	71.31	11/21	No invoice until February

* Voucher numbers were in two parts: the first signified the month; the second the serial number in that month.

† Invoice marked "Not included in inventory."

‡ The retail prices of these two items were given in the merchandise register as $25.45, and $10.30 respectively. They were billed to the customers on January 4, 1928.

In another file were kept the invoices for capital additions and other miscellaneous invoices and memoranda; invoices in this file were arranged according to date of payment. No invoices dated later than December 31, 1927, were discovered in the examination of the file. Memorandum records of goods on consignment with the company were found which disclosed the fact that three electric refrigerators in the furniture department were on consignment. Two were billed at $205.90 and one at $257.77.

The inventory sheets were examined and it was discovered that only two refrigerators were listed, one at $315 and the other at $250. Inquiry revealed that the third had been sold. The memorandum billings from the vendors were traced to the voucher register, where it was seen that two were still open items at $205.90 and $257.77. The other had been paid on December 4, 1927.

Customers' deposits totaling $2,050 were recorded in the general ledger under the caption "Customers' Deposits." The names of the individuals making deposits and withdrawals were entered in detail opposite the amounts. The cash receipts and disburse-

ments were seen in the cash receipts book and the check register. All entries appeared to be in order.

Criticize the audit of notes and accounts payable.

Prepare the schedules you would need to show the work done and make any necessary adjustments.

67. HOPKINS DEPARTMENT STORE—PART IX

FUNDED DEBT AND CAPITAL STOCK: HOW WOULD YOU VERIFY THE FUNDED DEBT AND CAPITAL STOCK OF THE HOPKINS DEPARTMENT STORE?

FUNDED DEBT

There was no reduction in the amount of the first mortgage note during the year under review. The holder of the note was questioned, and he stated that it was a first mortgage note on the property of the Hopkins Department Store, due October 1, 1929, and that interest which was payable at 5% had been paid to October 1, 1927. (Among the outstanding checks on December 31, 1927, was #36,327 drawn for $3,125 on December 29, 1927, in favor of the holder of the first mortgage.)

The terms of the second mortgage called for an annual reduction of $10,000 of the principal in equal quarterly installments. Interest at 5% per annum was also payable quarterly. Both interest and principal installments had been paid to December 31, 1927.

A certification that $40,000 6% debenture bonds were outstanding on December 31, 1927, was obtained from the registrar of the bonds. It was determined also that the interest which was payable semi-annually had been paid to November 1, 1927.

CAPITAL STOCK

The capital stock, $100 par value, of the Hopkins Department Store was closely held and not dealt in on any exchange. The treasurer of the store personally maintained the records relating thereto, which consisted of a Stock Transfer Book (a journal), a Stockholders' Ledger, and a book of certificates with stubs.

All transfers recorded in the Stock Transfer Book were traced to the Stockholders' Ledger and to the book of certificates. It

was observed that all canceled certificates were marked "canceled" and/or punched and attached to their original stubs; they were also properly endorsed and bore the required revenue stamps.

The certificate stubs and the Stockholders' Ledger showed that certificates were issued and outstanding as follows:

Certificate No.	Issued to	Number of Shares
1	H. A. Hopkins	550
2	R. E. Hopkins	100
7	J. A. Joyce	60
8	E. F. Lovejoy	80
11	H. A. Hopkins	100
12	S. P. Faulkner	20
13	W. W. Mitchell	10
14	J. A. Joyce	10
15	S. P. Faulkner	10
16	E. F. Lovejoy	30
17	A. L. Kraft	20
18	W. W. Mitchell	10

The Stock Certificate Book was thoroughly examined to ascertain that all certificates, which were serially numbered, were accounted for. The last certificate was missing, but on its stub was a notation stating that the certificate had been marked "Sample" and given to the attorney for the issue of the debenture bonds. The treasurer stated that this notation was correct.

Discuss critically the verification outlined above. Prepare any necessary adjusting entries and draw up schedules showing these accounts.

CHAPTER XI

AUDIT OF SURPLUS AND RESERVES

68. SECURITIES AND EXCHANGE COMMISSION—NO. 2

SURPLUS: SHOULD CAPITALIZED EARNED SURPLUS BE RETURNED TO THE SURPLUS ACCOUNT?

In an address by Mr. William W. Werntz, Chief Accountant of the Securities and Exchange Commission, made in December, 1938, before the American Accounting Association, the following case was cited:

A registrant included in its balance sheet at the close of the last fiscal year this item:

"Earned surplus (including $4,500,000 which had been capitalized as part of a $5,000,000 stock dividend in 1922 and returned to earned surplus upon reduction of capital stock from $6,000,000 to $1,500,000 in 1933) $5,295,273.45."

Conferences and correspondence brought out that in 1922 a stock dividend of 500% was declared and charged to earned surplus lest a tax be imposed upon the accumulated surplus of corporations. By 1933 earned surplus had dwindled. The company thereupon translated its $100 par stock into an equal number of no par shares with a stated value of $25. To record this exchange it was proposed to debit capital and credit earned surplus in the amount of $4,500,000, thus leaving $500,000 of the previously capitalized earned surplus in the capital stock account.

The registrant . . . sought to rationalize this entry on the ground that the $4,500,000 was earned surplus because the effect of a stock dividend followed by a reduction in stated value of the shares was not substantially different from a split up of shares in which case earned surplus would have been left intact. It was also claimed that the stockholders' action in 1933 was not substantially different from the rescission of a dividend pursuant to which no actual distribution of any portion of the company's assets had actually been made. It was thus argued that the two transactions, in this case eleven years apart, should be considered as one since during that period the registrant was a closed corporation and no representations had been made to creditors or to the investing public that the surplus had been permanently capitalized. As a final point the position was taken that since the $4,500,000 in question was derived from earnings and since assets were

never distributed to stockholders, it is proper, if not necessary, to reflect this amount at this time as earned surplus and not as capital surplus.

. . . .

As auditor, would you be willing to certify the figure for earned surplus?

69. B. A. CARAWAY COMPANY

INVENTORY RESERVE: HOW SHOULD A RESERVE FOR LOSSES ON INVENTORIES BE HANDLED IN THE BALANCE SHEET AND OPERATING STATEMENT?

The treasurer of the B. A. Caraway Company prepared the following statements to be submitted to the board of directors:

B. A. Caraway Company
Comparative Balance Sheets as of December 31, 1933 and 1932

Assets

		1933		1932
Current:				
Cash		$ 8,000.00		$ 10,000.00
Accounts Receivable		75,000.00		40,000.00
Inventories:				
Raw materials		80,000.00		60,000.00
Goods in process		125,000.00		90,000.00
Finished goods*		325,000.00		270,000.00
Total current assets		$ 613,000.00		$ 470,000.00
Plant	$1,098,000.00		$1,030,000.00	
Less reserve for depreciation	490,000.00	608,000.00	450,000.00	580,000.00
Prepaid expenses		4,500.00		5,000.00
		$1,225,500.00		$1,055,000.00

* A merchandise inventory reserve of $30,000.00, provided during the year ended December 31, 1931, and deducted from the finished goods inventory on the balance sheet at that date, was carried forward and applied against finished goods in valuing the inventory as at December 31, 1932. During 1933, however, market prices have shown a substantial advance, and this reserve is not required in valuing finished goods at December 31, 1933.

B. A. CARAWAY COMPANY (*Continued*)

COMPARATIVE BALANCE SHEETS AS OF DECEMBER 31, 1933 AND 1932

	1933	1932
LIABILITIES		
Current:		
Notes payable	$ 12,000.00	$ 7,000.00
Accounts payable	65,000.00	25,000.00
Accrued expenses	123,000.00	28,000.00
Total current liabilities	$ 200,000.00	$ 60,000.00
CAPITAL		
Capital stock, 5,000 shares (par value $100.00 each)	$ 500,000.00	$ 500,000.00
Surplus	495,500.00	495,000.00
Appropriated surplus for inventory revaluation	30,000.00	
	$1,225,500.00	$1,055,000.00

B. A. CARAWAY COMPANY

STATEMENT OF PROFIT AND LOSS SURPLUS, YEAR ENDED DECEMBER 31, 1933

Net sales	$205,000.00
Cost of sales	164,000.00
Gross profit	$ 41,000.00
Selling and administrative expenses	16,400.00
Operating profit	$ 24,600.00
Other charges, less other income	4,100.00
Net profit carried to surplus	$ 20,500.00
Surplus, December 31, 1932	495,000.00
	$515,500.00
Dividends paid ($4.00 per share on 5,000 shares)	20,000.00
Surplus, December 31, 1933	$495,500.00

B. A. CARAWAY COMPANY

STATEMENT OF COST OF GOODS SOLD, YEAR ENDED DECEMBER 31, 1933

Raw materials	$ 88,000.00
Labor	60,000.00
Overhead	76,000.00
	$224,000.00
Less increase in goods in process and finished goods inventories	60,000.00
Cost of goods sold	$164,000.00

Would you certify these statements?

70. ELWOOD COMPANY

SALES REVENUE: WHAT ADJUSTMENTS SHOULD BE MADE WHERE THE BOOKS HAVE BEEN INACCURATELY KEPT?

The Elwood Company, located in Detroit, Michigan, manufactured a patent vacuum cleaner which it sold to retail dealers of electrical supplies throughout the middle west. Desiring additional working capital for purposes of expansion, the company in August, 1926, interested a firm of investment bankers in the possibilities of a stock issue. Before underwriting this issue, however, the bankers requested an audit of the accounts as of July 31, 1926.

In the course of their examination the auditors prepared a comparative balance sheet and a statement of sales by months, which are given below:

ELWOOD COMPANY
BALANCE SHEETS
AS AT DECEMBER 31, 1925 AND JULY 31, 1926

ASSETS	December 31, 1925	July 31, 1926
Current:		
Cash	$ 180,000	$ 155,000
Accounts Receivable	637,000	640,000
Inventories (per physical count)	574,000	506,000
Prepayments	25,000	128,000
Total Current Assets	$1,416,000	$1,429,000
Fixed Assets, less reserve for depreciation	531,000	530,000
Investment in Elwood Service Company	50,000	50,000
Patents	16,000	12,000
Goodwill	200,000	200,000
	$2,213,000	$2,221,000

ELWOOD COMPANY (*Continued*)
BALANCE SHEETS
AS AT DECEMBER 31, 1925 AND JULY 31, 1926

LIABILITIES	December 31, 1925	July 31, 1926
Current:		
Accounts Payable	$ 150,000	$ 158,000
Accruals (commissions, etc.)	35,000	42,000
Reserve for Taxes	13,000	4,000
Total Current Liabilities	$ 198,000	$ 204,000
CAPITAL		
Preferred Stock—7% Cumulative	500,000	500,000
Common Stock	400,000	400,000
Surplus	1,115,000	1,117,000
	$2,213,000	$2,221,000

ELWOOD COMPANY
MONTHLY NET SALES* IN 1925 AND 1926

Month	1925		1926	
	Quantity	Amount	Quantity	Amount
January	3,680	$ 184,000	3,640	$ 182,000
February	3,720	186,000	3,680	202,400
March	3,996	199,800	3,880	213,400
April	4,080	204,000	3,920	215,600
May	4,220	211,000	4,200	231,000
June	4,704	235,200	4,740	260,700
July	4,488	224,400	5,011	275,105
August	4,440	222,000		
September	4,360	218,000		
October	4,300	215,000		
November	4,120	206,000		
December	3,892	194,600		
	50,000	$2,500,000	29,071	$1,580,205

* Not including sales of parts. The sale of repair parts and the servicing of cleaners were handled through a separate company.

Both of these schedules were drawn from the company's books. After the preparation of the statements, however, the auditors uncovered the following facts:

1. An investigation of the returned sales and allowances account brought to light an improper charge thereto early in July, 1926, of $500.00, for empty containers returned by the company to a vendor. By tracing the entry it was found that the offsetting credit had been

made to accounts receivable. At the time the full containers were received the company had charged them into purchases and set up a liability, which upon further investigation, was found to be included in the July 31, 1926, trial balance of the accounts payable ledger.

2. There was an error made in billing the Capital Hardware Company on July 28, 1926, for 120 cleaners at the regular list price. These cleaners were not shipped until August and the customer wrote in protesting the July billing. As the books had been closed for July the correction was made on the books in August.

3. The vice president in charge of sales had instructed the chief accountant to hold his books open for a few days after the close of the month in order to include heavy shipments that were made after the last day of July, 1926. Such shipments amounted to $30,250.00. In addition to his salary the vice president had a contract which called for a commission of 3% on net sales in excess of $250,000.00 in each month, payable the 15th of the month following.

4. Early in 1926 it was decided that something should be done to stimulate earlier liquidation of accounts due from customers. The course followed by the company to solve this problem was a shift from their traditional 2%, 10 days selling basis to a 7%, 10 days, 60 days net basis, effective on sales after May 31, 1926. Billings as shown by the books on which the discount period had not expired on the date of the audit amounted to $115,755.00.

5. Upon inquiry it developed that beginning in January, 1926, the company had dealt with certain customers on a consignment basis. It further developed that these transactions had been handled as if they were sales, whereas they were also included in the inventory of July 31, 1926. Factory costs of such consignments outstanding at July 31, 1926, were as follows:

Consigned 1926	Quantity	Unit Cost
January	5	$18.75
April	8	18.25
June	6	19.00

6. In order to build up goodwill with customers and consumers alike, the company guaranteed its product against defects in workmanship or damages sustained through shipment, full credit being allowed for such returns provided they were returned within thirty days of shipment from the factory. Reference to the records of the statistical department proved that, exclusive of handling charges, the average cost of reconditioning and making salable such returned goods was $10.00 per unit, and the handling charges $.50 each for those east and $1.00 each for those west of the Mississippi River. A schedule of returned sales for the four months ended July 31, 1926, was prepared.

1926	East of Mississippi	West of Mississippi
April	$6,000	$5,700
May	6,300	4,500
June	7,200	6,300
July	9,000	6,600

The records disclosed further that, as of July 31, 1926, the company had on hand 103 cleaners which had been returned and had not been reconditioned. These cleaners were included in the July 31, 1926, inventory at the manufacturing cost.

Show journal entries for all adjustments to be made upon the books, assuming that they had not as yet been closed.

Show adjusted balance sheet.

71. MASON WOOLEN COMPANY

INCOME DETERMINATION: WHERE A SPECIAL AGREEMENT AS TO INCOME GOVERNS THE COMPENSATION OF AN INDIVIDUAL HOW SHOULD THE INCOME BE AUDITED?

In July, 1923, the directors of the Mason Woolen Company offered Mr. F. C. Richards a three-year contract as treasurer and general manager of the organization. Mr. Richards accepted the offer, purchased 100 shares of the company's stock, and was elected a director. His contract specified, among other things, that:

> The Company agrees for and in consideration of the services to be rendered to it by said Richards to pay the said Richards a salary of twenty-five thousand dollars ($25,000) per annum, payable in equal monthly installments on the last day of each month, and in addition thereto as extra compensation to pay to the said Richards for each fiscal year of the Company ending June 30th, during the term of this contract a sum, if any, equal to seven per cent (7%) of so much of the net profits of the Company for such fiscal year as shall be in excess of three hundred and fifty thousand dollars ($350,000), provided, however, that for no year of such term shall such extra compensation exceed twenty thousand dollars ($20,000) per year. That such net profits of the Company shall be determined by the duly authorized and appointed auditors of the Company, whose decision shall be final.

The contract further provided that all taxes that should accrue during a fiscal year together with Richards' salary of $25,000 should be considered as expenses of the company, and that if the amount of Federal income tax as determined by the auditors should be at variance with the amount assessed by the Government the additional compensation already paid to Richards should be adjusted immediately upon demand by either party to the contract.

The first fiscal year under the contract ended June 30, 1924. The auditors determined the profits for that period, and calculated that Mr. Richards' 7% extra compensation amounted to $17,832.15.

The second fiscal year under the contract ended June 30, 1925. During the audit of the accounts for that year Mr. Richards had a conference with the auditors to discuss two points affecting the amount of additional compensation he was to receive. These points were:

1. The directors had authorized a rearrangement of machinery to the end that savings approximating $10,000 per year might be effected. During the fiscal year this work cost $45,964.50. Mr. Richards contended that the full amount should not be charged to operations during the current year but should be apportioned over a period of years because the benefits derived from the expenditure would affect subsequent earnings as well as those of the current year. Accordingly he had instructed the bookkeeper to enter the expenditure on the books so that it would be amortized over a period of five years including the current year. One-fifth of the amount had been charged to the operations of the current year and the balance had been set up on the books as a "Deferred Charge to Future Operations."

2. In order to stimulate sales, the company had offered to each customer the following "inside" or special discounts, in addition to cash discounts, on the customer's purchases in any calendar year amounting to $200,000 or over:

$200,000 to $300,000	1%
300,000 to 400,000	2%
400,000 to 500,000	3%
Over 500,000	4%

The first calendar year in which the special discounts were in effect was the year beginning January 1, 1924. To provide for the payment of these special discounts the company had set up an account called "Reserve for Special Discounts" to which was credited the full amount which the company might be called upon to refund—that

is, 4% of the gross sales. The amounts of additional discounts actually paid were charged to the reserve.

At June 30, 1925, the reserve account showed that during the fiscal year then ended \$176,848.05 had been credited to the reserve and that special discounts totaling \$56,451.23 had been paid to customers as of January 1, 1925. The special discounts allowed and paid for the calendar year 1924 were 30% of the amount reserved for that period. Mr. Richards contended that the reserve for the 18 months to June 30, 1925, should be reduced from a 100% basis to a 30% basis and that the adjustment should be added to the income account for the current year. He had already made a protest to the directors and the board had voted that if the auditors decided that, in view of subsequent experience, earnings in the previous year had been understated, the additional compensation which would have been paid Mr. Richards as of June 30, 1924, if no understatement had occurred, should be paid him in addition to the bonus for the year ended June 30, 1925. Sales for the six months beginning January 1, 1925, were \$2,345,074.

The profits for the fiscal year ended June 30, 1925, according to the books (without any adjustment of the reserve for special discounts) were as follows:

Net profit before income tax and before allowance for additional compensation due Richards	\$496,382.82
Deduct estimated income tax	48,956.30
	\$447,426.52
Deduct specific exemption in contract	350,000.00
	\$ 97,426.52
Additional compensation	\$ 6,819.86

If you had been the duly authorized and appointed auditor of this company's accounts, would you have approved the amortization of rearrangement expense in determining Richards' extra compensation?

What amount of extra compensation should be paid to Mr. Richards for the year ended June 30, 1925, and in adjustment of the compensation for the prior year, after making appropriate adjustment for customers' special discounts? You may assume that the income tax was 10% of net income before the deduction of the tax itself.

72. WICKFORD MANUFACTURING COMPANY[1]

DEPRECIATION: SHOULD DEPRECIATION ON A LEASED PLANT BE OMITTED FROM THE STATEMENTS?

The Wickford Manufacturing Company owned a fully-equipped plant not used in its current operations. On January 1, 1937, after having been idle since 1935, the plant was leased to the Madwell Company with a purchase option on a 4-year term on the following basis:

1. The Madwell Company was to pay an annual rental in monthly payments of a fixed amount.
2. The Madwell Company was to pay $3,750 quarterly to the lessor, which was to be applied towards its option for the purchase of the plant and such payments were to be applied against the purchase price in the event that the lessee exercised the option. Otherwise, these payments were to be considered as additional rent. The lessee had the privilege of exercising the option at any time during the 4-year lease period.

The cost of the plant to the Wickford Manufacturing Company was $400,000, and its book value was $350,000 at the beginning of the lease period. The price at which the lessee might exercise his option was $400,000. During the first year of the lease, the Madwell Company rehabilitated the plant and added a new garage building and equipment at a cost of $100,000.

Albers and Boothby, auditors of the Wickford Manufacturing Company, were asked to certify the statements at December 31, 1937, which omitted the annual depreciation of $15,000 on the plant. The management gave the following reasons:

1. The sales option price was $400,000, while the book value of the plant was $350,000.
2. If the option was not exercised, the benefit of the additions and improvements to the property would revert to the Wickford company.
3. The total depreciation for the 4-year period would amount to $60,000, while the depreciated value of the additions and improvements would have a value in excess of $60,000.

How should the Wickford Manufacturing Company treat the $15,000 it received annually on account of the option?

[1] Adapted from an accounting question in *The Journal of Accountancy*, April, 1939, p. 242.

Should Albers and Boothby certify the statements which omit the annual depreciation charge of $15,000?

How should the above transactions be set forth on the financial statements of the company?

73. KAUFMAN DEPARTMENT STORES, INC.[1]

DEPRECIATION: SHOULD STATEMENTS BE QUALIFIED WHERE FIXED ASSETS ARE SHOWN AT NOMINAL VALUES?

The depreciation policy of the company was as follows: Machinery, fixtures, and automobiles:

Machinery, fixtures, and automobiles were recorded in the accounts at cost and reserves provided to reduce the cost to a nominal value ($2). This practice was started in 1929 when the net book value ($1,463,649) was charged to surplus. In 1930, the additions ($870,466), were charged to surplus and since that time all additions have been charged to profit and loss. (The amounts were not segregated for 1931 to 1935, and for 1936 and 1937 were $30,953 and $144,205 respectively.) No provision for depreciation, as such, was included in the profit and loss statements.

Leaseholds and leasehold improvements:

Leaseholds, which had a value of $2,000,000 assigned thereto in 1913, were amortized through charges to profit and loss from 1917 to 1927, inclusive. The unamortized balance of $1,583,908 was charged to surplus in 1928.

The leasehold improvements were being amortized over the lives of the principal leases, which expire April 1, 1963.

Parking garage:

The two-story-open-sided steel-and-concrete parking garage erected in 1936 was being amortized so that the entire cost would be written off by April 1, 1963.

Warehouse building:

This building was of concrete, brick, and steel construction and was being depreciated at the rate of 2% per annum.

Outside properties:

[1] New York Stock Exchange Listing Application, A-11,180, December 9, 1938.

	Assets	Reserves
Land	$230,000	$
Building	325,750	224,518
Improvements	15,259	15,259
	$571,009	$239,777

The amount of land represented the cost of the land and a building thereon. In recording the cost, the company allocated no value to the building.

The building was located on leased ground and its cost was being amortized over the life of the lease, which would expire April 1, 1945, but which included an option under which an extension could be made until 1970.

A reserve had been provided by a charge to income in 1933 to eliminate from the accounts the cost of the improvements to the building; therefore, no provision for depreciation was included in the profit and loss statements.

EXHIBIT 1
KAUFMAN DEPARTMENT STORES, INC.

Year	Land	Buildings and Leasehold Improvements	Reserve for Depreciation	Machinery and Fixtures	Reserve for Depreciation
1930	....	$9,306,336*	$1,135,043	$3,039,377	$3,039,376
1931	....	9,305,336*	1,305,784	3,063,441	3,063,440
1932	....	9,305,336*	1,476,524	3,071,362	3,071,361
1933	....	9,213,626*	1,616,383	3,085,667	3,085,666
1934	....	9,213,626*	1,781,357	3,098,544	3,098,543
1935	$2,549,423	6,664,203	1,954,672	3,113,891	3,113,890
1936	2,549,423	6,773,048	2,128,109	3,137,132	3,137,131
1937	2,549,423	6,783,035	2,306,099	3,280,365	3,280,364

Year	Automobiles	Reserve for Depreciation	Depreciation Expense of Buildings	Net Income	Surplus
1930	$235,438	$235,437	$173,663	$1,122,662	$10,091,418
1931	238,567	238,566	170,740	648,705	10,076,780
1932	238,567	238,566	170,740	555,958[d]	9,234,220
1933	239,363	239,362	167,067	342,148	9,400,776
1934	240,384	240,383	164,974	818,793	9,819,023
1935	182,874	182,873	173,315	1,041,234	10,133,009
1936	190,585	190,584	173,437	1,513,664	10,220,992
1937	191,557	191,556	177,990	1,532,129	10,787,469

d = deficit
* Includes land.
SOURCE: Company reports.

If you were called upon to act as auditor for this company for the first time, for the year 1938, would the above treatment of fixed assets lead you to qualify the reports or certificates which you would sign?

74. FAIRWEATHER COMPANY

INTEREST EXPENSE: WHAT SIGNIFICANCE HAS THIS INTEREST ACCOUNT IN A BALANCE SHEET AUDIT?

The Fairweather Company presented the following balance sheet to the First National Bank requesting an unsecured loan of $25,000.00:

FAIRWEATHER COMPANY
BALANCE SHEET—JUNE 30, 1927

ASSETS		
Cash		$ 2,495.50
Petty cash on hand		18.67
Accounts receivable	$ 75,496.54	
Less Reserve for bad debts	12,460.00	63,036.54
Inventories:		
Raw material	$160,497.20	
Goods in process	24,695.00	
Finished goods	50,476.34	235,668.54
Prepaid items		7,876.39
Plant assets:		
Land and buildings		275,000.00
Machinery	$125,645.13	
Office furniture and equipment	11,386.19	
Automobiles	842.05	
	$137,873.37	
Less Reserve for depreciation	21,416.66	116,456.71
Deficit		15,647.06
		$716,199.41
LIABILITIES		
Notes payable		$150,000.00
Accounts payable		123,849.23
Accrued salaries and wages		17,350.18
Mortgage note payable		125,000.00
Capital stock		300,000.00
		$716,199.41

The bank asked that the Fairweather Company engage auditors to verify the above balance sheet, and in compliance with this request an auditor was appointed immediately.

At a conference between the company's attorney, the president of the bank, and the auditor, the desire for an expeditious audit was stressed. The president of the bank stated that he was familiar with the earnings of the company and the nature and extent of its business. He said that the bank was not interested in any statement of earnings but that it was primarily concerned with the net quick asset position.

The auditor agreed to proceed promptly on that basis and prepared a program for the guidance of his assistant. Entirely upon his own initiative that assistant departed from the program one day to the extent of analyzing the Interest account for the month of June, 1927. Following is a transcript of his work sheet:

INTEREST ACCOUNT—JUNE, 1927

	Dr.	Cr.
Interest paid to bank	$ 750.00	
Paid City—Interest on past due real estate taxes	141.56	
Adjustment of interest rate on trade acceptances discounted		$ 2.03
Protest fees on customer's bad check	2.50	
Interest paid to Treasurer on company's note to him—3 months at 6%	45.00	
Interest on instalment notes for automobiles purchased (Monthly payment on principal charged to asset account as paid)	5.32	
Fees paid to sheriff on writ of attachment for machinery not paid for	10.50	
Interest paid to finance company for advances on accounts receivable assigned	271.87	
Paid bank for overdrawn balance	1.67	
Paid to sundry trade creditors on overdue open accounts	16.16	
Dividends received on shares of stock in Manufacturers' Association		7.00
Interest on customers' notes		14.07
	$1,244.58	$23.10
	23.10	
Net debit	$1,221.48	

In your opinion, does the information in the above analysis of Interest have any bearing on the audit of the balance sheet? If so, how?

75. ILLINOIS BELL TELEPHONE COMPANY[1]

INCOME: HOW SHOULD ADJUSTMENTS BE HANDLED?

On August 16, 1923, the Illinois Commerce Commission entered an order, effective October 1, 1923, directing the Company to reduce its rates for four classes of subscribers' coin box service in the City of Chicago. The Company secured in the Federal Court injunctions staying the effect of this order. On April 30, 1934, the Supreme Court of the United States (*in the case of Illinois Bell Telephone Company vs. Lindheimer etc., et al.*, 292 *U. S.* 151, *which case is still pending in the United States District Court for the Northern District of Illinois, in Equity No.* 3746) finally held against the Company in these proceedings, and directed that the injunction be dissolved and that there be refunded to the Company's subscribers the excess charges which they had paid to the Company over the amounts which they would have paid had

[1] Prospectus dated October 16, 1935.

such reduced rates ordered by the Commission been in effect. Pursuant to this mandate of the Supreme Court, the District Court, by orders dated June 1, 1934, and June 11, 1934, directed the refunds and specified the conditions under which such refunds should be made. Important provisions of said orders were as follows: The Company was directed to proceed as expeditiously as possible to refund to its subscribers the said excess charges with interest at the rate of 5% per annum, computed from the 15th day of the month in which the overcharge was collected up to June 1, 1934, but not thereafter. Such refunds were directed to be made in cash, or to be applied as credits on overdue balances owed the Company by subscribers. Assignments of the subscribers' rights were prohibited, and the Company was released from all obligations to recognize any such assignments. Jurisdiction of the cause was retained by the Court for the purpose of supervising and enforcing the refunds therein ordered, and the subscribers and all persons claiming by, through or on their behalf were enjoined from taking any action at law or in equity, or before any other tribunal, or in any other manner whatsoever, to obtain any such refunds except only in such proceedings as they might take in that cause. Taxable costs of $69,690.70 were assessed against the Company and have been paid. Further provision was made that on and after June 1, 1937, the Company should be released as to all refunds which it had not been able to make in compliance with the terms of the orders of the Court, except as to those subscribers who had theretofore made claims for refunds.

. . . .

(*a*) 1. Decrees entered by the United States District Court in June, 1934, in the Chicago Rate Case, ordered refunds to certain Chicago coin box subscribers of amounts which had been included in the revenue accounts of the Company for the period from October 1, 1923, to May 31, 1934. The amounts thus ordered refunded were the sums charged subscribers for specified classes of coin box telephone service in excess of the sums chargeable pursuant to the provisions of an order of the Illinois Commerce Commission dated August 16, 1923, to be effective October 1, 1923, plus interest at 5% per annum to June 1, 1934.

2. Following the entry of this decree the Company, in June, 1934, adjusted its accounts. The adjustments affecting the Income Statement for 1934 were as follows:

Local Service Revenues	Decreased	$15,948,059
Depreciation	Decreased	15,948,059
Uncollectible Operating Revenues	Decreased	985,000
General Services and Licenses	Decreased	429,601
Interest Income	Increased	154,189
Other Interest Deductions	Increased	4,731,738
Federal Income Tax	Decreased	434,905

The adjustment in Local Service Revenues represented the estimated amount of refund for the period covered by the decree, exclusive of interest. In this connection, the Company, in view of statements contained in the opinion of the United States Supreme Court in the Chicago Rate Case regarding the Company's provision for depreciation during the period covered by the suit, adjusted its Depreciation expense account by an amount equal to the estimated principal amount to be refunded, with a corresponding reduction in its Depreciation Reserve.

The adjustment in Uncollectible Operating Revenues represented the Company's estimate of recoveries from recipients of refunds of amounts previously charged off as uncollectible.

The adjustment in General Services and Licenses represented the return by the American Telephone and Telegraph Company, parent of the Company, of a portion of prior payments to it under the License Contract, based on the adjustment of Local Service Revenues, and the adjustment in Interest Income represented interest at 5% per annum receivable from the parent company on the amount so returned.

The adjustment in Other Interest Deductions represented the Company's estimate of interest at 5% per annum to be paid on the principal amount of refund.

The adjustment in Federal Income Tax represented the effect of the above adjustments, as then estimated, on the Company's tax liability.

3. The foregoing adjustments reduced Net Income by $2,728,043 in 1934.

4. The Company now estimates that the principal amount refundable and interest thereon will aggregate respectively about $1,200,000 and $500,000 less than the estimates made and recorded in the accounts for June, 1934. Appropriate corrections in the accounts previously charged or credited in respect of these adjustments are not expected, when made, to add more than $400,000 to the Company's net income.

5. The Company estimates that of the amounts of Local Service Revenues subject to refund, about $400,000 represented revenues which had been credited to the accounts in 1934, $900,000 in 1933, and $1,000,000 in 1932.

. . . .

Depreciation

. . . The adjustment of $15,948,059 made in the Depreciation expense account in 1934, as part of the Chicago Rate Case adjustment . . . is deemed by the Company to have been an adjustment affecting depreciation expense accrued prior to 1933. If an appropriate portion of this adjustment were allocated to 1932 the percentage rate for that year would not differ materially from the rates for subsequent periods.

. . . .

Illinois Bell Telephone Company
Schedule A—Surplus

	Year 1934
Surplus Reserved—see Note (*a*)	
Balance at beginning of period	$16,248,774.77
Additions during period	452,648.60
Total	$16,701,423.37
Transferred to Unappropriated Surplus	$16,701,423.37
Balance at close of period	—

Note: (*a*) Surplus reserved in recognition of a possible liability for refunds to coin box subscribers in connection with the Chicago Rate Case while pending. In 1934 the amount of Surplus so reserved, being no longer required for this purpose, was transferred to Unappropriated Surplus. . . .

What alternative methods might the company have followed in accounting for the adjustments described above?

Comment on the method used by the company.

76. HOPKINS DEPARTMENT STORE—PART X

RESERVES, SURPLUS, AND MINUTES: HOW WOULD YOU VERIFY THE RESERVES, SURPLUS, AND MINUTES OF THE HOPKINS DEPARTMENT STORE?

RESERVES

In the trial balance given in Part I as of December 31, 1927, the balances of the surplus reserve accounts were as follows:

Reserve for Contingencies	$65,501.86
Reserve for Employees' Pensions	27,804.92
Reserve for Payment of Funded Indebtedness	60,000.00

The ledger of the Hopkins Department Store was examined and changes in these accounts which were made during the year 1927 were noted. The balance of the Reserve for Contingencies account was the same as at December 31, 1926, and no offsetting entries had been made. The Reserve for Employees' Pensions had been increased by $1,324.23.

This account had been credited for $2,824.23 in December and debited for $600 and $900 in June and December, respectively. The Reserve for Payment of Funded Indebtedness was a new account with two credits of $30,000 made in June and December.

Each of these reserve accounts had been set up voluntarily by the company. The Reserve for Contingencies was of some years standing and had been set up originally as a reserve against possible inventory shrinkages. As such it had varied in size with the inventory, but after December 31, 1924, when it became a more general reserve, it remained at $65,501.86.

The Reserve for Employees' Pensions was created in accordance with the wish of the founder of the store to provide for faithful employees upon their retirement from active service. There was no agreement or understanding with the employees that they would receive pensions; it was entirely voluntary on the part of the company. Two men had been retired and were receiving pensions of $75 a month each.

SURPLUS

The Surplus account was debited for the following items:

June—	Dividend on Capital Stock	$40,000.00
	Reserve for Retirement of Funded Indebtedness	30,000.00
October—	Additional Federal Income Tax	418.66
December—	Dividend on Capital Stock	40,000.00
	Reserve for Employees' Pensions	2,824.23
	Reserve for Payment of Funded Indebtedness	30,000.00

The account was credited for a refund of $201.01 on the 1924 Federal income tax, for profits on sale of real estate $39,341.25, and for profits from operations of $144,022.28.

MINUTES

Excerpts were taken from the minutes of the meetings of the Board of Directors as given below:

DIRECTORS' MEETINGS

January 15.	Voted: to authorize manager to employ expert to consider insurance problem, cost not to exceed $400. That the manager's budget, as presented, be approved.
February 12.	Voted: to retire J. A. Goodwin as of April 1 with a pension of $75 a month.
March 20.	Voted: to accept auditor's report for year ended December 31, 1926.
April 11.	Voted: that the manager be authorized to borrow on the company's notes from time to time, such amounts as he may deem to be required. No note, however, shall be for more than $10,000 nor shall

more than two such notes be issued in any one month nor the total of such notes at any one time exceed $50,000.

June 5. Voted: to declare 40% dividend on the capital stock payable June 29 to stockholders of record June 20. To set up out of Surplus a fund of $30,000 as a reserve for the payment of capital liabilities.

December 9. Voted: to declare dividend of 40% on capital stock payable December 30 to stockholders of record December 20. To add $2,824.23 to employees' fund. To set aside an additional $30,000 to provide for retiring capital liabilities.

STOCKHOLDERS' ANNUAL MEETING

March 20. President's report read and approved. Dividend declarations approved. Voted to continue to retain the same auditors.

Is any further verification required? Would you say that the directors' wishes had been carried out? Prepare schedules and adjustments of these balance sheet items.

CHAPTER XII

PRESENTATION OF FINDINGS

77. NATIONAL BELLAS HESS, INC.

AUDIT CERTIFICATES: WHEN SHOULD THE CERTIFICATE BE APPENDED TO SPECIFIC STATEMENTS?

NATIONAL BELLAS HESS, INC.
BALANCE SHEET, JULY 31, 1934

ASSETS		
Current and Working Assets:		
Cash in Banks	$ 164,200.01	
Cash on Hand and Postage	12,169.76	
Accounts Receivable, less Reserve	51,682.84	
Inventory—Merchandise at Cost or Market (Lower Figure)	1,018,889.40	
Inventory—Paper Stock and Supplies	38,295.27	
Prepaid Costs of Catalogues	75,049.00	
Prepaid Insurance, Rents, Investment, Etc.	16,275.34	
Total Current and Working Assets		$1,376,561.62
Other Assets:		
Assets Taken Over from National Bellas Hess Co., Inc.		
Customers' Mailing List	$ 499,994.00	
Machinery and Equipment, and Furniture and Fixtures	1.00	
Packing Material, Box and Stationery Supplies	1.00	
Catalogue Plates, Drawings, Etc.	1.00	
Trade Mark and Trade Names	1.00	
Leasehold at Kansas City	1.00	
Goodwill	1.00	
Total Assets Taken Over	$ 500,000.00	
Improvements, and Machinery and Equipment, less Reserve	38,298.33	
Organization Expense	55,228.58	
Total Other Assets		593,526.91
Total		$1,970,088.53

NATIONAL BELLAS HESS, INC. (*Continued*)
BALANCE SHEET, JULY 31, 1934

LIABILITIES			
Current Liabilities:			
Accounts Payable—Merchandise		$ 155,155.80	
Accounts Payable—Catalogue Costs		41,227.19	
Miscellaneous Expense Accruals		46,858.70	
Customers' Refund Checks Outstanding—Current		51,486.41	
Due to Customers		17,989.71	
Federal and State Income Taxes Payable—Accrued		30,387.73	
Current Portion of Note Payable to Receivers		12,000.00	
Total Current Liabilities			$ 355,105.54
Long Term Note Payable to Receivers—without Interest			45,531.12
Reserve for Old Company's Refund Checks			20,119.33
Due to Employees for Stock Participation			57,366.50
Capital:			
Common Capital Stock:			
Authorized—1,800,000 Shares at $1.00		$1,800,000.00	
Less Stock Reserved for Employees	$500,000.00		
Issued	15,101.00	484,899.00	
Net Issued and Outstanding		$1,315,101.00	
Surplus		176,865.04	
Total Capital			1,491,966.04
Total			$1,970,088.53

CERTIFICATE

We have examined the accounts and records of the National Bellas Hess, Inc., located at Kansas City, Missouri, and at New York, New York, and we certify that, in our opinion, the above Balance Sheet sets forth the correct financial condition of the Company at July 31, 1934.

MOUNT, CLAPP & CARTER,
Certified Public Accountants.

New York, N. Y., August 13, 1934.

NATIONAL BELLAS HESS, INC.
CONDENSED SUMMARY OF INCOME AND PROFIT AND LOSS FOR YEAR ENDED JULY 31, 1934

Sales, Less Returns and Allowances	$6,903,595.89
Cost of Sales, Operating, Administrative and Selling Expenses	6,749,197.26
Profit from Operation	$ 154,398.63
Income Credits—Interest, Discounts, Etc.	54,610.23
Gross Income	$ 209,008.86
Income Charges—Provision for Federal and State Income Taxes, and Interest	37,730.29
Net Income for the Period	$ 171,278.57
Surplus at Beginning of Period	5,586.47
Surplus at End of Period	$ 176,865.04

CERTIFICATE

We have examined the accounts and records of the National Bellas Hess, Inc., located at Kansas City, Missouri, and New York, and we certify that, in our opinion, the above statement sets forth the correct income for the period shown.

MOUNT, CLAPP AND CARTER,
CERTIFIED PUBLIC ACCOUNTANTS.

New York, N. Y., August 13, 1934.

What is the significance of attaching certificates to specific statements?

78. METROPOLITAN PERSONAL LOAN COMPANY[1]

CERTIFICATES: HOW MUCH INFORMATION SHOULD A CERTIFICATE CONTAIN?

In an amended prospectus submitted in connection with the registration of securities with the Securities and Exchange Commission, a balance sheet at March 31, 1936, showed Notes and Accounts Receivable of $368,112.39, which included $30,422 of the personal loan accounts acquired from the Continental Finance Corporation on March 1, 1933. These were acquired under a contract by which the Metropolitan purchased overdue accounts

[1] Adapted from S.E.C. Decisions, Vol. II, Part 2, pp. 808–809, 813.

having a face value of $41,444.71 for $20,722.35, which latter amount was set up as an asset on the books of the company.

After having paid $10,000 on the contract price, the company discovered that interest on 75% of the accounts purchased had been illegally compounded and was informed by state authorities that although it might collect the principal of these accounts, no further interest could be collected. Thereupon the company refused to pay the remainder of the contract price, but subsequently settled for $2,900, thus paying a total of $12,900 for accounts with a face value of $41,444.71. As of December 31, 1933, the amount ($7,822.35) by which the contract purchase price of these accounts was reduced was credited to a Reserve for Losses. Concurrently, the company recorded the remainder of the face of these accounts, $20,722.36 as an asset on its books; this amount was offset by credits of $3,228.98 to the reserve for losses, $7,000 to income, and $10,493.38 to surplus. Approximately $22,000 of the Continental accounts were writen off as uncollectible subsequent to March 31, 1936, although the collectibility of these accounts had not changed since that date.

The accountants' certificate accompanying the statements included the following:

> During 1933 the Company acquired the accounts of the Continental Finance Company at a discount of 50% of the unpaid balance and at the close of the year was successful in securing a reduction of $7,822.35 of the contract price. Under the direction of the officers of the Company the entire balance of the accounts purchased were recorded on the books, crediting the increase of $10,561.49 to surplus while $7,000 arising out of reduction of contract liability was credited to profit and loss as indicated on the schedules.

Comment on the accountants' certificate in the light of the facts discussed above.

79. CHARLES DARNER MANUFACTURING COMPANY

AUDIT WORKING PAPERS
YEAR ENDED DECEMBER 31, 1928

Working Trial Balance

Charles Darner Manufacturing Company, Boston, Massachusetts

December 31, 1928

TB(1)

Assets	Trial Balance		Adjustments		Expense	Income	Assets	Liabilities	
Current:									
Cash:									
On Deposit..............A	$150,627.40			(1) $ 10,006.40			$140,621.00		
Certificates of Deposit....A	50,000.00						50,000.00		
Accrued Interest.......A			$ 375.00(4)				375.00		
In Transit...............A			10,225.60(1)				10,225.60		
On Hand................A	1,000.00			(2) 292.34			707.66		
							201,929.26*		
Marketable Securities..........B	81,500.00			(10) 4,687.50			76,812.50		
Accrued Interest...........B			716.10(11)				716.10		
							77,528.60*		
Notes and Trade Acceptances.....									
Receivable:................C	15,527.40			(5) 15,527.40					
Customers..............									
Trade Acceptances......C			2,637.30(5)				2,637.30		$ 12,277.40
Notes..................C			9,640.10(5)				9,640.10		42.00
									$ 12,319.40
Accrued Interest.........C			42.00(5)				42.00		1,390.10
									$ 10,929.30
Less: Allowance for Doubtful C				(5) 1,390.10				$ 1,390.10	
							12,319.40*	1,390.10*	
Accounts Receivable:..........D	294,240.20			(6) 294,240.20					
Customers................D			244,083.98(6)				244,083.98		
Foreign Drafts Drawn......D	25,390.25						25,390.25		$269,474.23
									16,000.00
									$253,474.23
Less: Allowance for Doubtful and Discounts..........D		15,000.00		(6) 1,000.00				16,000.00	2,211.00
									$255,685.23
Trade Creditors' Debit Balances..................D			2,211.00(18)				2,211.00		
							271,685.23*	16,000.00*	
	$618,285.25	$15,000.00	$269,931.08	$327,143.94			$563,462.49	$17,390.10	

* Figures in green.

Working Trial Balance (*Continued*)

Charles Darner Manufacturing Company, Boston, Massachusetts

December 31, 1928

TB(2)

		Trial Balance	Adjustments		Expense	Income	Assets	Liabilities	
Assets (*Continued*)									
Current: (*Continued*)									
Merchandise Inventories:	E	$1,137,454.30		(21)$1,137,454.30					
Raw Materials on Hand	E		$ 197,420.83(21)	(20) 3,098.44			$ 194,322.39		
Raw Materials in Transit	E	13,321.40	4,342.20(17) 8,947.00(19)				26,610.60		
Work in Process	E		124,231.06(21)	(20) 217.76			124,013.30		
Finished Goods	E		753,199.79(21)	(20) 2,035.56			751,164.23		
Goods on Consignment	E		19,050.00(6)				19,050.00		
Manufacturing Supplies	E		59,440.87(21)				59,440.87		
Waste	E		3,161.75(21)				3,161.75		
Advance on Raw Materials	E		18,470.41(18)				18,470.41		
							1,196,233.55*		
Cash Surrender Value—Life Insurance	F	5,300.00	10,701.63(12)	(12) 5,300.00			10,701.63		10,701.63
Less: Loan	F			(12) 4,537.00				4,537.00	4,642.86
Accrued Interest	F			(12) 105.86				105.86	6,058.77
							10,701.63*	4,642.86*	
Other Assets:									
Mortgages Receivable	G_3	3,000.00					3,000.00		
Accrued Interest	G_3		12.25(13)				12.25		
Accts. Rec.—Officers and Employees	G_2		33.62(2) 1,250.00(6)				1,283.62		6,093.25
Advances to Salesmen	G_2	4,500.00	750.00(6)	(22) 2,237.55 (3) 142.82			2,869.63		
Loans to Employees	G_2	1,500.00	190.00(2) 250.00(1)				1,940.00		
Note Receivable—Officer	C		1,500.00(5)				1,500.00		
Accrued Interest	C		25.00(5)				25.00		
Customer's Note Rec.—Due after 12/31/29	C		1,750.00(5)				1,750.00		
Accrued Interest	C		43.75(5)				43.75		
Investments									
Outside Real Estate	G	35,800.00					35,800.00		
Less: Allow. for Depreciation	G			(23) 457.45				457.45	
Miscellaneous Stock	G		1.00(10)				1.00		
									Other Assets
Accts. Rec.—Warren Mfg. Co. (Customer Advance)	G		21,120.30(6)				21,120.30		69,966.05 457.45
Transportation Claims	G		620.50(6)				620.50 69,966.05*	457.45*	69,508.60
Totals		$1,200,875.70	$1,226,511.96	$1,155,586.74			$1,276,901.23	$5,100.31	

* Green.

Working Trial Balance (*Continued*)

Charles Darner Manufacturing Company, Boston, Massachusetts
December 31, 1928

TB(3)

Assets (*Continued*)	Trial Balance		Adjustments		Expense	Income	Assets	Liabilities	
Permanent:									
Land . . . . H	$ 99,510.00						$ 99,510.00		
Buildings . . . . H	1,060,486.70			(7)$ 8,690.00			1,051,796.70		
Less: Allowance for Depreciation . . . . H_2		$ 480,910.20	$ 25.93(9)					$ 480,884.27	
Machinery and Equipment . . . . H	1,398,625.60		8,690.00(7)	(8) 2,890.00			1,404,425.60		
Less: Allowance for Depreciation . . . . H_2		471,400.10	{2,155.22(9) {2,441.40(8)					466,803.48	
Automobiles . . . . H	12,844.30			(8) 541.87			12,302.43		
Less: Allowance for Depreciation . . . . H_2		6,450.20	611.87(8)	(9) 163.75				6,002.08	
Office Furniture and Fixtures . . . . H	74,144.80			(8) 225.00			73,919.80		$2,641,954.53
Less: Allowance for Depreciation . . . . H_2		33,096.70	{840.85(9) {200.00(8)					32,055.85	985,745.68
							2,641,954.53*	985,745.68*	$1,656,208.85 Net
Patents I	50,000.00			(14) 300.00			49,700.00		
Less: Amortization		34,990.50	1,185.30(15)					33,805.20	$ 49,700.00
							49,700.00*	33,805.20*	33,805.20
Goodwill . . . . J	100,000.00						100,000.00		$ 15,894.80 Net
							100,000.00*		
Deferred Charges:									
Bond Discount Unamortized . . . . K_1	61,457.18			(26)17,586.10			43,871.08		
Organization Expense Deferred . . . . K_2	41,500.00						41,500.00		
Operating Supplies . . . K_3	7,162.70						7,162.70		
Unexpired Insurance Premiums . . . . K_4	3,773.62			(24) 562.69			3,210.93		
Prepaid Taxes . . . . . . K_5	14,115.20			(25) 441.38			13,673.82		
Prepaid Interest . . . . . BB			1,584.86(28)				1,584.86		
Prepaid Wages . . . . K_6	310.00			(16) 25.74			284.26		
Prepaid Expenses . . . . A_{3a2}			75.00(3)				75.00		
							111,362.65*		
	$2,923,930.10	$1,026,847.70	$17,810.43	$31,426.53			$2,903,017.18	$1,019,550.88	

* Green.

Working Trial Balance (*Continued*)

Charles Darner Manufacturing Company, Boston, Massachusetts
December 31, 1928

TB(4)

Liabilities		Trial Balance	Adjustments		Expense	Income	Assets	Liabilities	
Current:									
Notes Payable:	BB	$180,000.00	$180,000.00(27)						
For Borrowed Money									
Banks	BB			(27)$ 50,000.00				$ 50,000.00	
Brokers	BB			(27) 25,000.00				25,000.00	
Officer	BB			(27) 15,000.00				15,000.00	{2,582.25 Current
For Machinery Purchases	BB			(27) 5,164.50				5,164.50	{2,582.25 Deferred
								95,164.50*	
Trade Acceptances Payable									
For Merchandise	BB			(27) 84,835.50				84,835.50	$95,164.50
								84,835.50*	2,582.25 Deferred
Drafts Against Letters of Credit	AA	20,050.20		(17) 4,342.20				24,392.40	
								24,392.40*	$92,582.25 Current
Accounts Payable	CC	121,444.20	121,444.20(18)	(19) 18,484.35					
Trade Creditors	CC		1,416.90(6)	(18) 133,294.49				150,569.74	
				(3) 207.80					
Officers and Employees	CC			(18) 8,831.12				8,831.12	
Unclaimed Wages	DD	1,197.30						1,197.30	
Customers' Credit Balances	D1			(6) 401.48				401.48	
								160,999.64*	
Accrued Accounts:									
Salaries and Wages	EE	21,116.00	18.36(2)					21,097.64	
Interest—Bonds	EE	11,875.00		(30) 1,166.65				13,041.65	
" —Other	EE			(28) 612.50				612.50	
Commissions	EE	8,350.00						8,350.00	
Water	EE			(29) 1,680.23				1,680.23	
Insurance	EE			(24) 183.60				183.60	
								44,965.62*	
Dividend Payable:									
Common Stock—Declared 12/20/28, payable 1/15/29	HH			(31) 20,000.00				20,000.00	
								20,000.00*	
		$364,032.70	$302,879.46	$369,204.42				$430,357.66	

* Green.

WORKING TRIAL BALANCE (*Continued*)

CHARLES DARNER MANUFACTURING COMPANY, BOSTON, MASSACHUSETTS
DECEMBER 31, 1928

TB(5)

	Trial Balance		Adjustments		Assets	Liabilities	Surplus	
LIABILITIES (*Continued*)								
Deferred Income:								
Prepaid Interest—Notes Receivable..................C				(5)$ 136.50		$ 136.50		
Bonded Indebtedness:								
First Mortgage 5 % Gold Bonds due August 1, 1937........FF		$ 630,000.00				630,000.00		
Less: In Treasury...........FF	$ 4,000.00				$ 4,000.00			
Capital:								
Capital Stock:								
7 % Cumulative Preferred Authorized and Issued..GG		500,000.00				500,000.00		
Common								
Authorized............GG		1,500,000.00				1,500,000.00		
Less: Unissued.........GG	450,000.00				450,000.00			
In Treasury.......GG	50,000.00				50,000.00			
Surplus:								
Balance Dec. 31, 1928.......HH		1,211,210.65	$1,211,210.65(32)	(32) 1,072,499.70				$1,072,499.70
Net Profit for the year......HH			256,202.55(33)	(32) 256,202.55				
Dividends Paid and Declared								
Preferred...............HH			35,000.00(32)				35,000.00	
Common................HH			{80,000.00(32) {20,000.00(31)				100,000.00	
Additional Assessment Federal Income Taxes 1926.HH			2,491.60(32)				2,491.60	
	$504,000.00	$3,841,210.65	$1,604,904.80	$1,328,838.75	$504,000.00	$2,630,136.50	$137,491.60	$1,072,499.70

WORKING TRIAL BALANCE (*Continued*)

CHARLES DARNER MANUFACTURING COMPANY, BOSTON, MASSACHUSETTS
DECEMBER 31, 1928

TB(6)

Income	Adjustments		Expense	Income	
Gross Sales	$ 25,400.00(6)	(33)$2,585,173.88		$2,559,773.88	$2,559,773.88
Less: Returns and Allowances	73,170.82(33)		$ 73,170.82		99,301.58
Discounts Allowed	26,130.76(33)		26,130.76		$2,460,472.30 Net Sales
Cost of Goods Sold:					
Inventory, January 1, 1928	1,225,691.60(33)		1,225,691.60		
Purchases	15,300.10(19) 1,269,556.50(33) 4,342.20(17)		1,289,198.80		
Freight Inward	13.82(2) 41,225.50(33)		41,239.32		
Less: Discounts Earned		(33) 17,395.43		17,395.43	
Direct Labor	227,870.54(33)		227,870.54		
Indirect Labor	25.74(16) 44,338.12(33)		44,363.86		
Light, Heat and Power	1,680.23(29) 49,737.65(33)		51,417.88		
Depreciation	101,005.44(33)	(9) 2,017.40	98,988.04		
Repairs	2,610.00(19) 9,152.24(33)		11,762.24		
Electrical Supplies and Expenses	9,636.35(33)		9,636.35		
Local Taxes	18,838.88(33) 441.38(25)		19,280.26		Amortization
Manufacturing Supplies	40,870.71(33)		40,870.71		of Patents
Insurance	746.29(24) 6,689.54(33)		7,435.83		See TB(8)—Other Deductions $2,755.88
Auto and Trucking Expenses	12,543.32(33)		12,543.32		
Miscellaneous (Factory Exp.)	9,323.96(33)		9,323.96		
Less: Inventory, December 31, 1928	5,351.76(20)	(6) 19,050.00 (33) 1,150,775.70 (17) 4,342.20 (19) 8,947.00		1,177,763.14	
Sales of Waste		(33) 36,673.93		36,673.93	
	$3,221,693.45	$3,824,375.54	$3,188,924.29	$3,791,606.38	

Working Trial Balance (*Continued*)

Charles Darner Manufacturing Company, Boston, Massachusetts
December 31, 1928

TB(7)

Expenses	Adjustments		Expense	Income
General and Administrative:				
Officers' Salaries	$ 90,000.00(33)		$ 90,000.00	
Office Salaries	37,725.34(33)		37,725.34	
Office Supplies and Expenses	470.00(19)		470.00	
Professional Services	300.00 (14) 9,635.00 (33)		9,935.00	
Telephone, Telegraph and Postage	104.25 (19) 2,179.65 (33)		2,283.90	
Depreciation—Furniture	6,318.41(33)	(9) 840.85	5,477.56	
Dues and Subscriptions	4,767.34(33)		4,767.34	
Traveling (Executives)	17.80(3) 6,600.68(33)		6,618.48	
Miscellaneous	23.50(1) 9,965.48(33) 40.00(3)		10,028.98	
			167,306.60*	
Selling:				
Salesmen's Salaries	15,263.34(33)		15,263.34	
Freight and Express Out	36.54(2) 12,933.67(33)		12,970.21	
Advertising	3,643.21(33)		3,643.21	
Traveling	142.82(3)		142.82	
Commissions	2,237.55(22) 90,329.33(33)		92,566.88	
Supplies and Expense	4,303.16(33)		4,303.16	
Credit and Collection	75.00(3) 4,036.46(33)		4,111.46	
Miscellaneous	632.75(33)		632.75	
			133,633.83*	
	$301,781.28	$840.85	$300,940.43	

Traveling
$ 6,618.48
142.82
$ 6,761.30

Miscellaneous
$10,028.98
632.75
$10,661.73

* Green.

Working Trial Balance (*Continued*)

Charles Darner Manufacturing Company, Boston, Massachusetts
December 31, 1928

TB(8)

Other Income and Deductions	Adjustments		Expense	Income	Net Income from Outside Property $ 4,562.70
Net Income from Outside Property		(33) $ 4,562.70		$ 4,562.70	457.45
Income from Marketable Securities		(33) 3,582.50		3,582.50	
Unclaimed Wages Charged Off		(33) 1,430.96		1,430.96	$ 4,105.25
Miscellaneous Income		(33) 1,393.61		1,393.61	
Interest Paid—Bonds	$ 1,166.65 (30) 32,314.61 (33)		$ 33,481.26		INTEREST $33,481.26
Interest Paid—Other	105.86 (12) 13,596.12 (33)	(1) 315.20 (28) 972.36	12,414.42		12,414.42
Interest Earned	25.75 (5)	(4) 375.00 (1) 177.50 (33) 4,612.30 (11) 716.10 (13) 12.25		5,867.40	$45,895.68 5,867.40 $40,028.28
Organization Expenses Amortized	20,750.00 (33)		20,750.00		
Amortization—Bond Discount	17,586.10 (26)		17,586.10		BAD DEBTS
Amortization—Patents	3,941.18 (33)	(15) 1,185.30	2,755.88	Transferred to Mfg. Expenses—TB(6)	$ 8,794.88 2,390.10
Bad Debts Written Off	8,794.88 (33)		8,794.88		
Provisions for Bad Debts	1,390.10 (5) 1,000.00 (6)		2,390.10		$11,184.98 897.44
Bad Debts Recovered		(33) 897.44		897.44	
Adjusting Securities to Market	4,686.50 (10)		4,686.50		$10,287.54
Life Insurance Premiums—Officers	5,426.00 (33)	(33) 376.00	5,050.00		
Increase in Cash Value—Life Insurance		(12) 864.63 (33) 1,074.70		1,939.33	LIFE INSURANCE $ 5,050.00
State Taxes	2,808.06 (33)		2,808.06		1,939.33
Loss on Sale of Capital Assets	403.60 (8)		403.60		
Depreciation—R. E. Investments	457.45 (23)		457.45		$ 3,110.67
	$114,452.86	$22,548.55	$111,578.25	$19,673.94	

Working Trial Balance (*Continued*)

Charles Darner Manufacturing Company, Boston, Massachusetts
December 31, 1928

TB(9)

Recapitulation	Trial Balance		Adjustments		Expense	Income	Surplus		Assets	Liabilities
1	$ 618,285.25	$ 15,000.00	$ 269,931.08	$ 327,143.94					$ 563,462.49	$ 17,390.10
2	1,200,875.70		1,226,511.96	1,155,586.74					1,276,901.23	5,100.31
3	2,923,930.10	1,026,847.70	17,810.43	31,426.53					2,903,017.18	1,019,550.88
4		364,032.70	302,879.46	369,204.42						430,357.66
5	504,000.00	3,841,210.65	1,604,904.80	1,328,838.75			$ 137,491.60	$1,072,499.70	504,000.00	2,630,136.50
6			3,221,693.45	3,824,375.54	$3,188,924.29	$3,791,606.38				
7			301,781.28	840.85	300,940.43					
8			114,452.86	22,548.55	111,578.25	19,673.94				
	$5,247,091.05	$5,247,091.05	$7,059,965.32	$7,059,965.32	$3,601,442.97	$3,811,280.32				
						3,601,442.97				
					Net Profit Before Taxes	$ 209,837.35				
					Federal and State Income Taxes	33,850.60(34)				(34)33,850.60
					Net Profit Carried to Surplus	$ 175,986.75		175,986.75		
							$ 137,491.60	$1,248,486.45		
					Balance Surplus Dec. 31, 1928		1,110,994.85			1,110,994.85
							$1,248,486.45	$1,248,486.45	$5,247,380.90	$5,247,380.90

ADJUSTMENTS

CHARLES DARNER MANUFACTURING COMPANY,

BOSTON, MASSACHUSETTS

DECEMBER 31, 1928

1.	Cash in Transit	$ 10,225.60(1)	
	Employee's Loan	250.00(2)	
	Miscellaneous Expense	23.50(7)	
	Interest Earned		$ 177.50(8)
	Interest Paid		315.20(8)
	Cash on Deposit		10,006.40(1)
	To adjust Cash on Deposit....A_1G_2	10,499.10*	10,499.10*
2.	Advances to Employees	190.00(2)	
	Accrued Wages	18.36(4)	
	Accounts Receivable—Employees	33.62(2)	
	Freight In	13.82(6)	
	Freight Out	36.54(7)	
	Cash on Hand		292.34(1)
	To reduce Fund to actual cash on hand at 12/31/28 as per count $A_3A_{3a2}G_2$	292.34*	
3.	Miscellaneous Expense (Adm.)	40.00(7)	
	Traveling Expense (Adm.)	17.80(7)	
	Traveling Expense (Selling)	142.82(7)	
	Credit and Collection	75.00(7)	
	Prepaid Expenses	75.00(3)	
	Accounts Payable—Trade Creditors		207.80(4)
	Advances to Salesmen		142.82(2)
	To provide for items in Petty Cash applicable to year under review A_{3a2}	350.62*	350.62*
4.	Accrued Interest—Certificates of Deposit	375.00(1)	
	Interest Earned		375.00(8)
	To provide for accrued interest at 12/31/28....A_2		
5.	Trade Acceptances Receivable	2,637.30(1)	
	Notes Receivable—Customers (Current)	9,640.10(1)	
	Accrued Interest	42.00(1)	
	Notes Receivable—Customer (Other)	1,750.00(2)	
	Accrued Interest	43.75(2)	
	Note Receivable—Officer	1,500.00(2)	
	Accrued Interest	25.00(2)	
	Providing Allowance for Doubtful Notes	1,390.10(8)	
	Interest Earned	25.75(8)	
	Prepaid Interest (Deferred Income)		136.50(5)
	Allowance for Doubtful Notes		1,390.10(1)
	Notes Receivable per Books		15,527.40(1)
	To segregate and provide for accrued and prepaid interest and for doubtful notes....C	17,054.00*	17,054.00*

* Figures in green.

ADJUSTMENTS (*Continued*)
CHARLES DARNER MANUFACTURING COMPANY,
BOSTON, MASSACHUSETTS
DECEMBER 31, 1928

6. Accounts Receivable—Customers........$	244,083.98(1)	
Accounts Receivable—Officers and Employees..........	1,250.00(2)	
Accounts Receivable—Affiliated Company..........	21,120.30(2)	
Transportation Claim..........	620.50(2)	
Sales..........	25,400.00(6)	
Accounts Payable—Trade Creditors..........	1,416.90(4)	
Advances to Salesmen..........	750.00(2)	
Goods on Consignment..........	19,050.00(2)	
Increasing Allowance for Doubtful Accounts..........	1,000.00(8)	
Accounts Receivable per Books..........		$ 294,240.20(1)
Customers' Credit Balances..........		401.48(4)
Inventory P & L 12/31/28..........		19,050.00(6)
Allowance for Doubtful Accounts..........		1,000.00(1)
To segregate, increase allowance for doubtful and reduce consigned goods to cost..........$D_1G_2ED_3$	314,691.68*	314,691.68*
7. Machinery and Equipment..........	8,690.00(3)	
Buildings..........		8,690.00(3)
To correct error in classification..H		
8. Allowance for Depreciation—Machinery and Equipment..........	2,441.40(3)	
Allowance for Depreciation—Autos and Trucks..........	611.87(3)	
Allowance for Depreciation—Off. Furniture and Fixtures..........	200.00(3)	
Loss on Sale of Capital Assets..........	403.60(8)	
Machinery and Equipment..........		2,890.00(3)
Autos and Trucks..........		541.87(3)
Office Furniture and Fixtures..........		225.00(3)
To adjust for items sold or scrapped during the year..........H_1H	3,656.87*	3,656.87*
9. Allowance for Depreciation—Buildings	25.93(3)	
Allowance for Depreciation—Machinery and Equipment..........	2,155.22(3)	
Allowance for Depreciation—Off. Furniture and Fixtures..........	840.85(3)	
Allowance for Depreciation—Autos and Trucks..........		163.75(3)
Depreciation (Mfg.)..........		2,017.40(6)
Depreciation (Adm.)..........		840.85(7)
To adjust depreciation expense for the year..........H_2	3,022.00*	3,022.00*
10. Decrease in Value of Securities..........	4,686.50(8)	
Investment in Misc. Stock (Other Assets)	1.00(2)	
Marketable Securities..........		4,687.50(1)
To adjust to lower of cost or market, and to segregate..........B		

* Figures in green.

ADJUSTMENTS (*Continued*)
CHARLES DARNER MANUFACTURING COMPANY,
BOSTON, MASSACHUSETTS
DECEMBER 31, 1928

11. Accrued Interest—Marketable Securities	$ 716.10(1)	
Interest Earned		$ 716.10(8)
To provide for accrued interest at 12/31/28 ... B		
12. Cash Surrender Value—Life Insurance	10,701.63(2)	
Interest Paid	105.86(8)	
Loan on Life Insurance		4,537.00(2)
Accrued Interest		105.86(2)
Cash Value per Books		5,300.00(2)
Increase in Cash Surrender Value		864.63(8)
To adjust to actual value at 12/31/28 and segregate loan and accrued interest thereon ... F	10,807.49*	10,807.49*
13. Accrued Interest—Mortgages Receivable	12.25(2)	
Interest Earned		12.25(8)
To provide for accrual at 12/31/28 G_3		
14. Professional Services	300.00(7)	
Patents		300.00(3)
To eliminate retainer expense ... I		
15. Allowance for Amortization-Patents	1,185.30(3)	
Amortization of Patents		1,185.30(8)
To reduce year's write-off ... I		
16. Indirect Labor	25.74(6)	
Prepaid Wages		25.74(3)
To reduce to actual prepaid 12/31/28 K_6		
17. Purchases	4,342.20(6)	
Raw Materials in Transit	4,342.20(2)	
Drafts against Letters of Credit		4,342.20(4)
Inventory P & L 12/31/28		4,342.20(6)
To provide for unentered Draft AA E		
18. Accounts Payable per Books	121,444.20(4)	
Trade Creditors' Debit Balances	2,211.00(1)	
Advances on Raw Materials	18,470.41(2)	
Accounts Payable—Trade Creditors		133,294.49(4)
Accounts Payable—Officers and Employees		8,831.12(4)
To segregate ... CC E	142,125.61*	142,125.61*
19. Purchases	15,300.10(6)	
Raw Materials in Transit	8,947.00(2)	
Repairs (Mfg.)	2,610.00(6)	
Telephone and Telegraph	104.25(7)	
Office Supplies	470.00(7)	
Accounts Payable—Trade Creditors		18,484.35(4)
Inventory P & L 12/31/28		8,947.00(6)
To provide for unentered merchandise and expense invoices. . E CC_1	27,431.35*	27,431.35*

* Figures in green.

ADJUSTMENTS (*Continued*)
CHARLES DARNER MANUFACTURING COMPANY,
BOSTON, MASSACHUSETTS
DECEMBER 31, 1928

20. Inventory P & L 12/31/28............$	5,351.76(6)	
Raw Materials on Hand............		$ 3,098.44(2)
Work in Process..................		217.76(2)
Finished Goods...................		2,035.56(2)
To adjust for errors in prices and computations................E_1		5,351.76*
21. Raw Materials on Hand..............	197,420.83(2)	
Work in Process.....................	124,231.06(2)	
Finished Goods......................	753,199.79(2)	
Manufacturing Supplies...............	59,440.87(2)	
Waste...............................	3,161.75(2)	
Inventory per Books...............		1,137,454.30(2)
To segregate....................E	1,137,454.30*	
22. Commissions (Salesmen)..............	2,237.55(7)	
Accounts Receivable—Officers and Employees....................		2,237.55(2)
To credit with commissions applicable to year under review.......G_2		
23. Depreciation—Outside Real Estate.....	457.45(8)	
Allowance for Depreciation—Real Estate........................		457.45(2)
To provide for depreciation......G_1		
24. Insurance...........................	746.29(6)	
Unexpired Insurance Premiums.......		562.69(3)
Accrued Insurance.................		183.60(4)
To adjust to correct prepayals and accruals at 12/31/28..........K_4		
25. Local Taxes.........................	441.38(6)	
Prepaid Taxes.....................		441.38(3)
To correct prepayal at 12/31/28.K_5		
26. Amortization of Bond Discount........	17,586.10(8)	
Unamortized Bond Discount.........		17,586.10(3)
To provide for year's amortization K_1		
27. Notes Payable per Books.............	180,000.00(4)	
Notes Payable for Borrowed Money—Banks..........................		50,000.00(4)
Notes Payable for Borrowed Money—Brokers........................		25,000.00(4)
Notes Payable for Borrowed Money—Officer.........................		15,000.00(4)
Notes Payable for Machinery........		5,164.50(4)
Trade Acceptances Payable..........		84,835.50(4)
To segregate.................BB		180,000.00*
28. Prepaid Interest.....................	1,584.86(3)	
Accrued Interest...................		612.50(4)
Interest Paid......................		972.36(8)
To provide for prepayal and accrual at 12/31/28................BB		

* Figures in green.

ADJUSTMENTS (*Continued*)
CHARLES DARNER MANUFACTURING COMPANY,
BOSTON, MASSACHUSETTS
DECEMBER 31, 1928

29. Light, Heat and Power.................$	1,680.23(6)	
Accrued Water......................		$ 1,680.23(4)
To provide for accrual at 12/31/28 EE$_3$		
30. Interest Paid—Bonds..................	1,166.65(8)	
Accrued Interest....................		1,166.65(4)
To adjust accrual at 12/31/28...FF		
31. Dividend Declared—Surplus............	20,000.00(5)	
Dividend Payable...................		20,000.00(4)
To provide for dividend declared payable 1/15/29 to stock of record 12/25/28...................HH		
32. Dividends Paid—Preferred............	35,000.00(5)	
Dividends Paid—Common.............	80,000.00(5)	
Additional Assessment—1926 Federal Taxes...........................	2,491.60(5)	
Surplus per Books, 12/31/28...........	1,211,210.65(5)	
Profit and Loss (Net Profit)..........		256,202.55(5)
Surplus 12/31/27...................		1,072,499.70(5)
To revert to opening balance and to analyze for the year.........HH$_1$		
33. Gross Sales........................		2,585,173.88(6)
Returns and Allowances...............	73,170.82(6)	
Discounts Allowed....................	26,130.76(6)	
Inventory, January 1, 1928............	1,225,691.60(6)	
Purchases............................	1,269,556.50(6)	
Freight In...........................	41,225.50(6)	
Discounts Earned...................		17,395.43(6)
Direct Labor.........................	227,870.54(6)	
Indirect Labor.......................	44,338.12(6)	
Light, Heat and Power................	49,737.65(6)	
Repairs..............................	9,152.24(6)	
Manufacturing Supplies...............	40,870.71(6)	
Depreciation.........................	101,005.44(6)	
Local Taxes..........................	18,838.88(6)	
Auto and Trucking Expenses...........	12,543.32(6)	
Electrical Supplies and Expenses........	9,636.35(6)	
Miscellaneous Factory Expenses........	9,323.96(6)	
Insurance............................	6,689.54(6)	
Sales of Waste.....................		36,673.93(6)
Inventory, December 31, 1928........		1,150,775.70(6)
Officers' Salaries.....................	90,000.00(7)	
Office Salaries........................	37,725.34(7)	
Office Supplies and Expenses Misc......	9,965.48(7)	
Professional Services..................	9,635.00(7)	
Traveling (Executives)................	6,600.68(7)	
Dues and Subscriptions................	4,767.34(7)	
Telephone, Telegraph and Postage......	2,179.65(7)	
Depreciation—Furniture and Fixtures...	6,318.41(7)	
Commissions........................	90,329.33(7)	
Salesmen's Salaries....................	15,263.34(7)	
Freight and Cartage Out...............	12,933.67(7)	
(*Forward*)	$3,451,500.17	$3,790,018.94

ADJUSTMENTS (*Continued*)
CHARLES DARNER MANUFACTURING COMPANY, BOSTON, MASSACHUSETTS
DECEMBER 31, 1928

	(*Brought Forward*)	$3,451,500.17	$3,790,018.94
	Selling Supplies and Expenses	4,303.16(7)	
	Credit and Collection	4,036.46(7)	
	Advertising	3,643.21(7)	
	Miscellaneous Selling Expenses	632.75(7)	
	Unclaimed Wages Charged Off		1,430.96(8)
	Bad Debts Recovered		897.44(8)
	Miscellaneous Income		1,393.61(8)
	Income from Marketable Securities		3,582.50(8)
	Net Income from Outside Property		4,562.70(8)
	Increase in Value—Life Insurance		1,074.70(8)
	Dividends on Officer's Life Insurance		376.00(8)
	Interest Earned		4,612.30(8)
	Interest Paid—Bonds	32,314.61(8)	
	Interest Paid—Other	13,596.12(8)	
	Bad Debts Written Off	8,794.88(8)	
	State Taxes	2,808.06(8)	
	Organization Expense Amortized	20,750.00(8)	
	Officer's Life Insurance Premiums	5,426.00(8)	
	Amortization of Patents	3,941.18(8)	
	Surplus (Net Profit)	256,202.55(5)	
	Totals	$3,807,949.15	$3,807,949.15
	To reopen income and expense accounts closed into Surplus		
34.	Federal and State Income Taxes (Estimated)	33,850.60(9)	
	Accrued Federal and State Income Taxes		33,850.60(9)
	To provide for estimated Federal and State Income Taxes for the year ... EE_4		

Summary Schedule of Cash
Charles Darner Manufacturing Company,
Boston, Massachusetts
December 31, 1928

A

Cash in Banks:			
Third National	A_1	$75,555.63	
Commonwealth National	A_1	49,632.77	
Bay State Trust Co.	A_1	15,432.60	$140,621.00
Certificates of Deposit	A_2		50,000.00
Cash on Hand	A_3		707.66
			$191,328.66
Add:			
Interest Accrued on Certificates of Deposit	A_2 J.E.#4		375.00
Deposit in Transit	A_1 J.E.#1		10,225.60
			$201,929.26
			F.S.

Summary of Bank Reconciliations
Charles Darner Manufacturing Company,
Boston, Massachusetts
December 31, 1928

A_1

	Third National	Commonwealth National	Bay State Trust	Total	
Balance per bank statement	$84,192.43	$49,622.77	$15,432.60	$149,247.80	
Add: Error by bank in deposit	....	10.00	....	10.00	
	$84,192.43	$49,632.77	$15,432.60	$149,257.80	
Deduct: Outstanding checks	8,636.80	....	....	8,636.80	
Cash on deposit per S. S & Co. A	$75,555.63	$49,632.77	$15,432.60	$140,621.00	
Additions					
Deposit in transit	10,225.60	....	....	10,225.60	J.E.#1
Postdated check returned (employee's loan)	....	250.00	....	250.00	J.E.#1
Bank charges not on books	23.50	....	....	23.50	J.E.#1
	10,249.10*	250.00*	....	10,499.10*	J.E.#1
	$85,804.73	$49,882.77	$15,432.60	$151,120.10	J.E.#1
Deductions					
Interest on deposits	177.50	....	....	177.50	J.E.#1
Interest rebated on Notes Payable anticipated	....	....	315.20	315.20	J.E.#1
	177.50*	....	315.20*	492.70*	J.E.#1
Balance per books 12/31/28 A_{10}	$85,627.23	$49,882.77	$15,117.40	$150,627.40	

Verification Included

Amounts on deposit and in transit confirmed by direct communication
Second verification made as of 1/15/29

Checks examined 12/1/28 to 1/15/29 inclusive
Recorded receipts traced to depositories for same period.
Cash book footings tested for same period.

* Figures in green.

Summary—Cash on Deposit

Per above summary	$140,621.00
Per schedule A_2, certificates of deposit	50,375.00
	$190,996.00

F. S.

Bank Reconciliations
Charles Darner Manufacturing Company, Boston, Massachusetts
December 31, 1928

A_{1a}

Third National Bank, Boston, Mass.				
Balance per bank statement .... A_{1a2}				$84,192.43
Additions				
Deposit in transit (cr. by bank 1/2/29) .... A_{1a2}			$10,225.60	
Bank charges—not on books			23.50	10,249.10
				94,441.53
Deductions				
	No.	*Amount*		
Outstanding checks 6/16/26	8,462	$ 420.55		
	10,902	3,225.95		
	10,925	2,862.80		
	10,998	2,127.50	$ 8,636.80	
Interest on deposits—not on books			177.50	8,814.30
Balance per books .... A_1				$85,627.23
Commonwealth National Bank, Boston, Mass.				
Balance per bank statement .... A_{1a2}				$49,622.77
Additions				
Postdated check returned—(Ralph Goodhue, employee's loan)			250.00	
Error by bank in deposit (Corrected 1/2/29)			10.00	260.00
Balance per books .... A_1				$49,882.77
Bay State Trust Company, Boston, Mass.				
Balance per bank statement .... A_{1a2}				15,432.60
Deduct: Interest rebated on anticipation of Notes Payable—not on books				315.20
Balance per books .... A_1				$15,117.40

F. S.

Third National Bank
Boston, Massachusetts

Gentlemen: A_{1a1}

Our auditors, Seymour, Sibley & Company, are making their annual examination of our accounts. Will you kindly furnish them in the enclosed addressed envelope, the following information:

(1) Bank statement to the close of business January 15, 1929.
(2) Balance on deposit with you as of December 31, 1928 showing regular and any special deposits.
(3) Notes held by you of which we are the maker, showing amounts, dates, when due, rate of interest, interest paid and description of collateral held.
(4) Description of any securities held by you for this company.

A_{1a1} (*Continued*)

(5) Description of any other liabilities to you direct or contingent, not covered above.

Very truly yours,

CHARLES DARNER MFG. CO.
PETER CRANSTON—*Treas.*

[NOTE: Similar letters were sent to each of the company's banks.]

February 20, 1929

Seymour, Sibley & Co.,
50 Federal St.,
Boston, Mass.

A_{1a2}

Gentlemen:

As requested by the Charles Darner Mfg. Co. we are enclosing their bank statement to the close of business January 15, 1929. The company had on regular deposit with us as of December 31, 1928 a balance of $84,192.43. They also held certificates of deposit as follows:

Certificate No.	Date of Issue	Amount	Due	Interest	Interest Credited	
1956	10/1/28	$20,000	Demand	4%	None	A_2
1957	10/1/28	10,000	Demand	4%	None	

As of December 31, 1928 the company was liable to us on notes as follows:

Date	Amount	Due Date	Interest Rate	Paid to	Endorsed by	
11/15/28	$5,000	1/5/29	6%	1/5/29	Charles Darner	BB
11/10/28	5,000	1/10/29	6%	1/10/29	Charles Darner	
11/10/28	5,000	1/20/29	6%	1/20/29	Charles Darner	
12/9/28	5,000	2/9/29	6%	2/9/29	Charles Darner	
12/20/28	5,000	2/10/29	6%	2/10/29	Charles Darner	

At that date we were also holding for the Charles Darner Mfg. Co. a note for collection of the following description:

Maker, J. J. Collins; Amount, $600.00; Due, 12/31/28 C

The company had no further liability to us either direct or contingent, as of December 31, 1928, nor did we hold as of that

A_{1a2} (*Continued*)

date any special deposits, securities or collateral for security of indebtedness.

Very truly yours,

THIRD NATIONAL BANK
BY F. WATKINS, *Cashier*

[NOTE: Bank statement for December showed charge of $23.50 as well as interest and rebates, and the bank statement for January confirmed receipt on 1/2/29 of deposit in Transit of $10,225.60.]

F. S.

[NOTE: Similar confirmations received from the Commonwealth National Bank and the Bay State Trust Company have been omitted.]

SECOND BANK RECONCILIATIONS
CHARLES DARNER MANUFACTURING COMPANY,
BOSTON, MASSACHUSETTS
JANUARY 15, 1929

A_{1b}

	No.	Amount		
Third National Bank				
Balance per bank statement			$101,216.90	
Deduct: Outstanding checks:				
6/16/26	8462	$ 420.55		
	11218	6,299.10		
	11219	21.66		
1/14/29 Petty Cash	11220	532.40	7,273.71	
Balance per books				$ 93,943.19
Commonwealth National Bank				
Balance per bank statement and books				32,667.22
Bay State Trust Company				
Balance per bank statement and books				18,779.21
Total cash on deposit per books				$145,389.62
Proof				
Balance per books, January 1, 1929				$150,627.40
Add: Receipts Jan. 1 to 15, 1929			$ 96,201.20	
Deduct: Disbursements Jan. 1 to 15, 1929			101,438.98	5,237.78
Balance per books, January 15, 1929				$145,389.62

F. S.

CERTIFICATES OF DEPOSIT
CHARLES DARNER MANUFACTURING COMPANY, BOSTON, MASSACHUSETTS
DECEMBER 31, 1928

A2

Cert. No.	Date of Issue	Bank	Due Date	Amount		Interest Rate	Interest Accrued		Verification
							Time	Amount	
1956	10/1/28	Third National Bank, Boston, Mass. A_{1a2}	Demand	$20,000.00		4%	3 mos.	$200.00	Correspondence
1957	10/1/28	Third National Bank, Boston, Mass.	"	10,000.00	$30,000.00	4	"	100.00	" A_{1a2}
3888	12/1/28	Commonwealth National Bank, Boston, Mass.	"		20,000.00	4½	1 mo.	75.00	"
		Balance per ledger	12/31/28	(A)	$50,000.00			$375.00	

J.E. #4

Jan. 5, 1929.

Received of Representative of Seymour, Sibley & Co. Certificates of Deposit amounting to $50,000.00, this being all the Certificates of Deposit for which I am accountable to the Charles Darner Mfg. Co.

PETER CRANSTON

F. S.

Summary—Cash on Hand
Charles Darner Manufacturing Company,
Boston, Massachusetts
December 31, 1928

A_3

Cash Fund per Books 12/31/28				$1,000.00
Deductions				
Cash Count 1/5/29	A_{3a}			
Advances to Employees	A_{3a1}			
B. Brown	G_2	$125.00		
H. Thomas	G_2	40.00		
C. A. Austin	G_2	25.00	$190.00	
Accrued Payroll	A_{3a1}		18.36	
Accounts Receivable Employees	A_{3a1}		33.62	
Freight In	A_{3a2}		13.82	
Freight Out	A_{3a2}		36.54	292.34
Cash on Hand per Balance Sheet	(A) J. E.#2			$ 707.66

A. T.

Verification Included

Counted twice: 1/5/29 and 1/16/29

Vouchers examined from 1/1/29 to 1/16/29—last no. 982

A. Teppert

CASH COUNT A_{3a}

Counted by A. Teppert		Date 1/5/29			Time 9 A.M.
Currency					
Twenties		4	80.00		
Tens		4	40.00		
Fives		11	55.00		
Twos		10	20.00		
Ones		19	19.00		
			214.00	214.00	
Coin (Silver)					
Dollars					
Halves		12	6.00		
Quarters		14	3.50		
Dimes		24	2.40		
Nickels		44	2.20		
Cents		8	.08		
			14.18	14.18	
Coin (Gold)					
Twenties					
Tens					
Fives					
Two-Fifty ($2.50)					
					$ 228.18
Wrapped Coin	list attached			A_{3a1}	160.50
Checks for Deposit	" "			A_{3a1}	89.20
Cash Items	" "			A_{3a1}	165.00
Pay Roll Advances	" "			A_{3a1}	70.36
Undistributed Disbursements	" "			A_{3a2}	280.94
Bad Checks	" "			A_{3a1}	33.62
Cash Sales				A_{3a1}	27.80*
				Total	1,000.00

*Red

Received of representatives of Seymour, Sibley & Co., Cash and Cash items as hereon listed amounting to ($1,027.80)

One Thousand Twenty Seven............ 80/100 DOLLARS

this being all cash or cash items in my possession for which I am accountable to Charles Darner Mfg. Co.

Arthur James

Boston	1/5/29
Place	Date

A. T.

Cash Count
Charles Darner Manufacturing Company, Boston, Massachusetts
January 5, 1929

A_{3a1}

Wrapped Coin:			
Halves	5 rolls at $10.00	$50.00	
Quarters	7 " " 10.00	70.00	
Dimes	6 " " 5.00	30.00	
Nickels	4 " " 2.00	8.00	
Pennies	5 " " .50	2.50	$160.50
Checks for Deposit:			
12/28/28 L. G. Sampson—Check cashed (Salesman)		50.00	
1/4/29 H. Jacobs—Misc. Cash Sale		19.20	
1/3/29 Wm. Chase—Payment on Mtge. held by Co.		20.00	89.20
Cash Items:			
11/20/28 B. Brown—Employee's Advance—Originally	$200	125.00	
12/15/28 H. Thomas— " " "	40	40.00	165.00
Payroll Advances:			
1/1/29 E. R. Roberts—Week ended 12/29/28	Vacation	27.00	
12/29/28 C. A. Austin — " " "	Loan	25.00	
" G. Snow — " " "	Discharged	18.36	70.36
Bad Checks (Accounts Receivable—Employees):			
10/2/28 L. B. Small —Former Employee	G_2	24.00	
7/25/28 R. H. Macomber— " "	G_2	9.62	33.62
Cash Sales:			
1/2/29 Included under checks for deposit		19.20*	
" " " cash in count		8.60*	27.80*
			To A_{3a}

A. T.

* Red.

CASH COUNT
CHARLES DARNER MANUFACTURING COMPANY,
BOSTON, MASSACHUSETTS
JANUARY 5, 1929

A_{3a2}

Undistributed Disbursements:

12/31/28	#971	American Exp.	Frt. Out	$ 6.20	
"	972	N. Y., N. H. & H.	" "	30.34	
"	973	" " "	" In	13.82	
1/1/29	974	American Exp.	" "	.96	
"	975	N. E. Towel Sup. Co.	Dec. Service	1.00	
"	976	J. Dumas—Cleaning Office Dec.		24.00	
"	977	Credit Service Co. 6/30/28 to 6/30/29		150.00	(Due 12/31/28)
1/2/29	978	Stamped Envelopes		30.00	
"	979	American Exp. Frt. In.		8.32	
1/4/29	980	" " "	Out	2.30	
"	981	D. Anderson	Suppers	14.00	$280.94

BASIS FOR ADJUSTMENT

DEBIT			CREDIT: Cash	CREDIT: Accts. Pay.	CREDIT: Advances to Salesmen
First Count:					
Advances to Employees			A_{3a1} 190.00		
Accrued Payroll			A_{3a1} 18.36		
Accts. Rec.—Employees			A_{3a1} 33.62		
Freight Out	(Above)	6.20, 30.34	36.54		
" In	"		13.82		
Misc. Expense (Adm.)	"	1.00, 24.00		25.00	
Credit and Collection	"			75.00	
Prepaid Expenses	"			75.00	
Second Count:					
Misc. Expense (Adm.)				A_{3b2} 15.00	
Traveling " "				A_{3b2} 17.80	
" " (Sell.)		A_{3b2} 74.50, 68.32			142.82
			292.34	207.80 CC	142.82
			J. E. #2	J. E. #3	J. E. #3

A. T.

CASH COUNT A_{3b}

Counted by A. Teppert		Date 1/16/29			Time 9 A.M.
Currency:					
Twenties		1	$ 20.00		
Tens		3	30.00		
Fives		7	35.00		
Twos		34	68.00		
Ones		8	8.00		
			$161.00	$161.00	
Coin (Silver):					
Dollars		0	$ 0		
Halves		10	5.00		
Quarters		15	3.75		
Dimes		36	3.60		
Nickels		14	.70		
Cents		13	.13		
			$ 13.18	$ 13.18	
Coin (Gold):					
Twenties			0		
Tens			0		
Fives			0		
Two-Fifty ($2.50)			0		
			0	0	$ 174.18
Wrapped Coin	List attached				0
Checks for Deposit	" "			A_{3b1}	582.40
Cash Items	" "			"	125.00
Pay Roll Advances	" "				0
Undistributed Disbursements	" "			A_{3b1}	84.80
Bad Checks	" "			"	33.62
				Total	$1,000.00

Received of representatives of Seymour, Sibley & Co., Cash and Cash Items as hereon listed amounting to ($1,000.00)

One Thousand.................................DOLLARS

this being all cash or cash items in my possession for which I am accountable to...
Charles Darner Mfg. Co...

Arthur James

Boston	1/16/29
Place	Date

A. T.

SECOND CASH COUNT
CHARLES DARNER MANUFACTURNG COMPANY,
BOSTON, MASSACHUSETTS
JANUARY 16, 1929

A_{3b1}

Checks for Deposit:		
1/14/29 Reimbursement Check, #11220—Third Nat'l.	$532.40	
1/15/29 O. A. Waitt—Check cashed for customer	50.00	582.40
Cash Items:		
11/20/28 B. Brown—Employee's Advance	105.00	
12/15/28 H. Thomas " "	20.00	125.00
Undistributed Disbursements:		
1/15/29 #1027 Am. Express—Frt. Out	4.60	
" 1028 " " " "	10.20	
" 1029 Postmaster Stamped Envelopes	70.00	84.80
Bad Checks:		
10/2/28 L. B. Small—Former Employee	24.00	
7/25/28 R. H. Macomber	9.62	33.62
		To A_{3b}

A. T.

CASH COUNT
CHARLES DARNER MANUFACTURING COMPANY
BOSTON, MASSACHUSETTS
DECEMBER 31, 1928

A_{3b2}

Reconciliation:		
Cash Count 1/16/29		$1,000.00
Additions		
Voucher Jacket containing vouchers #971 to 1026 inc.—1/1/29 to 1/14/29	$532.40	
Deductions		
Reimbursement Check #11220	532.40	
Cash Fund per Books 12/31/28		$1,000.00

NOTE: All vouchers from January 1 to 14, 1929, represented by the above check for $532.40, were examined for proper approval and for expenses or other items applicable to the period under review.

Vouchers for January 1929 to #982 were inspected and, where necessary, adjusted as the result of our first cash count at 1/5/29. Inspection of vouchers paid between 1/5/29 and 1/16/29 showed the following Accrued Expenses:

1/6/29 #	990 City Water Co. —Dec. 1928 Misc. Adm.		$15.00	A_{3a2}
"	992 L. C. Downs —Traveling Dec. 1928	G_2	74.50	
1/8/29	1,000 L. G. Sampson — " " "	G_2	68.32	
"	1,002 Colonial Garage—Taxi service " "		17.80	

A.T.

MARKETABLE SECURITIES
CHARLES DARNER MANUFACTURING COMPANY, BOSTON, MASSACHUSETTS
DECEMBER 31, 1928

B

Cert. No.	Name of Security	Class	Total Par Value or Shares	Book Value	Cost	Market Value	Lower of Cost or Market	Date Last Coupon Clipped	Interest Accrued	How Verified: Examination	How Verified: Prices N. Y. Times
2058–67	Atchison Topeka & Santa Fe Ry.	4½–48	$10,000.00	$ 9,800.00	$ 9,800.00	$14,700.00	$ 9,800.00	10/1	$112.50	Examination	N. Y. Times
469–76	Chesapeake Corporation	5 –47	10,000.00	9,800.00	10,000.00	9,700.00	9,700.00	10/1	125.00	"	" "
B 99–113	Detroit Edison	5 –62	15,000.00	14,550.00	14,550.00	14,600.00	14,550.00	10/1	187.50	"	" "
10221–27	New York Edison	6 –41	7,000.00	6,900.00	6,900.00	7,300.00	6,900.00	11/1	70.00	"	" "
A 6667	U. S. Liberty Loan 4th	4¼–38	10,000.00	9,975.00	10,000.00	9,925.00	9,925.00	10/15		"	" "
6668	" " " " "	" "	10,000.00	9,975.00	10,000.00	9,925.00	9,925.00	10/15	221.10	"	" "
26698	" " " " "	" "	5,000.00	4,987.50	5,000.00	4,962.50	4,962.50	10/15		"	" "
106778	Baltimore and Ohio R. R.	Common	50 shares	4,250.00	4,800.00	6,000.00	4,800.00			"	" "
29922	U. S. Steel Corporation	"	50 "	6,012.50	6,250.00	9,000.00	6,250.00			"	" "
499	West Newton Knitting Co.* G	"	525 "	5,250.00	5,250.00	1.00	1.00				
				$81,500.00	$82,550.00	$86,113.50	$76,813.50		$716.10		

* No balance sheet of recent date; probably worthless. Plant not operating. This was taken in settlement of a debt in 1927.
A.T.

January 5, 1929
Received of Representative of Seymour, Sibley & Co. the above listed securities.
Peter Cranston

Summary

	Current	*Other*
Lower of Cost or Market Values	$76,812.50	$1.00
Accrued Interest	716.10	.....
Per Balance Sheet	$77,528.60	$1.00

J.E. #10

Decrease in Value of Securities	$4,686.50	
Investments—(Other Assets)	1.00	
Marketable Securities		$4,687.50

J.E. #11

Accrued Interest	716.10	
Interest Earned		716.10

A.T.

NOTES AND TRADE ACCEPTANCES RECEIVABLE
CHARLES DARNER MANUFACTURING COMPANY, BOSTON, MASSACHUSETTS
DECEMBER 31, 1928

C

Date	Maker	Due Date	Amount		Int. Rate	Time	Interest Accrued	Interest Prepaid	How Verified Correspondence	How Verified Misc.	Origination, Endorsers, Other Remarks
10/1/28	Black Mfg. Co., Boston, Mass.	1/31/29		$ 490.10	5 %				Letter (C2) (C3)	Inspected	Original 1/1/26 Worthless
8/31/28	Collins, J. J. " "	11/30/28	$ 600.00		6				"	"	Returned unpaid*
"	" " " " "	12/31/28	600.00		6				" C1A1a2	Letter-Bank	Out for collection*
"	" " " " "	1/31/29	600.00	1,800.00	6				"	Inspected	
7/1/28	French Co., O. A. " "	1/1/30		1,750.00	5	6 mos.	$ 43.75		"	"	
9/1/28	Jones, Robert " "	9/1/29		1,500.00	5	4 "	25.00		"	"	Officer
12/1/28	Pratt Co., E. E. " "	1/1/29	1,211.82		..				"	CB106 Cash Receipt	Trade Acceptance
"	" " " " "	2/1/29	1,425.48	2,637.30	..				"	Inspected	" "
10/31/28	Warren and Sampson " "	6/30/29		4,550.00	6	6 "		$136.50	"	"	Endorsed—J. A. Warren
10/1/28	Young, F. S. " "	4/1/29		2,800.00	6	3 "	42.00		"	"	
	Balance per Books 12/31/28			$15,527.40			$110.75	$136.50			
								J.E. #5			

Recapitulation		Analysis			Accrued Interest	Allowance for Doubtful		Net (S. S. & Co.)
Trade Acceptances			$ 2,637.30	J.E. #5				$ 2,637.30
Notes Receivable—Customers (Current)		$ 490.10				$ 490.10	....	
		1,800.00				900.00	$ 900.00	
		4,550.00					4,550.00	
		2,800.00	9,640.10		$ 42.00		2,842.00	8,292.00
			12,277.40**		42.00**	1,390.10**		10,929.30**
Note Receivable—Customer (Other)*	G		1,750.00		43.75			1,793.75
Note Receivable—Officer "	G		1,500.00		25.00			1,525.00
			$15,527.40		$110.75	$1,390.10		$14,248.05
					J.E. #5			

January 5, 1929
Received from Representative of Seymour, Sibley & Co. the notes marked "inspected" in the above schedule.

Peter Cranston

**Green

* Saw letter from Committee of Creditors, stating that there would be a final dividend of approximately 50 %.

A.T.

VERIFICATION OF NOTES OUT FOR COLLECTION

The Third National Bank of Boston,
Boston, Mass.

Gentlemen: C_1

Our records show that you were holding, as of the close of business December 31, 1928, a note, in the process of collection for our account, as follows:

Maker	*Due Date*	*Amount*
J. J. Collins	12/31/28	$600.00

If the above is correct, will you kindly sign this letter in the space indicated below and return direct to our auditors, Seymour, Sibley and Company, 50 Federal St., Boston, Mass? We enclose a stamped envelope for your convenience.

Very truly yours,

CHARLES DARNER MFG. CO.
By PETER CRANSTON

At December 31, 1928, we were holding in the process of collection for the account of Charles Darner Mfg. Co., a note as listed above.

(*Signed*) THIRD NATIONAL BANK
By T. WATKINS, *Cashier*

A_{1a2}

VERIFICATION OF NOTES RECEIVABLE

Black Manufacturing Company
Boston, Mass.

Gentlemen: C_2

For the purpose of our regular audit, kindly furnish our auditors, Seymour, Sibley and Co., 50 Federal St., Boston, Mass., with the following information relative to your note liability to this Company at December 31, 1928:

Amount of Note
Date made
Due Date
Rate of Interest
Date to which Interest has been paid
Collateral or Endorsers

We enclose a stamped envelope for your convenience.

Very truly yours,

CHARLES DARNER MFG. CO.
By PETER CRANSTON

(Note: Similar letters were sent to the makers of each of the notes listed in C.)

Seymour, Sibley & Co., C_3
50 Federal St.,
Boston, Mass.

Gentlemen:

As of December 31, 1928 we had the following note liability to the Charles Darner Mfg. Co.

Amount	*Date Made*	*Due Date*	*Interest*	*Date to Which Interest Had Been Paid*
$490.10	10/1/28	1/31/29	5%	9/30/28

Very truly yours,

BLACK MFG. CO.
CYRUS MCCUTCHEON, *Treas.*

SUMMARY SCHEDULE OF ACCOUNTS RECEIVABLE
CHARLES DARNER MANUFACTURING COMPANY,
BOSTON, MASSACHUSETTS D

Customers' Accounts Receivable	D_1	$244,083.98
Foreign Drafts Drawn	D_2	25,390.25
		$269,474.23
Less: Allowance for Doubtful Accounts and Discounts	D_3	16,000.00
		$253,474.23
Add: Trade Creditors' Debit Balance	D_4	2,211.00
		$255,685.23

A.T.

Accounts Receivable
Charles Darner Manufacturing Company, Boston, Massachusetts
December 31, 1928

D1

Verification No.	Customer†	Trial Balance Dr.	Trial Balance Cr.	Realized to 1/31/29	December	November	October	July, Aug., Sept.	Apr., May, June	Jan., Feb., Mar.	Over One Year	Remarks
190	Waitt, O. A.	$ 2,361.25		$ 922.80	$ 962.55	$ 300.00				$ 175.90		$175.90 Allowance 1/9/29
191	Walsh, F. G.	1,250.00					$ 500.00	$ 250.00	$ 500.00			Officer
192	Warren Mfg. Co. G	21,120.30		220.10	9,554.30	7,190.65	4,155.25					Affiliated
193	Wason, O. F.	966.55		10.00(a) 490.00	466.55							
	Western Maryland R.R.	620.50									$ 620.50	Tr. Claim
194	Winch & Co., C. H.		$ 45.16									
195	Wright, A. A.	3,910.55		992.60	1,210.60	466.60	840.25			400.50		400.50 Bad Debts 1/4/29
196	Yerxa, B. D.	25,400.00			10,650.00	7,850.00	6,900.00					Consignment
197	Yost, O. O.	1,822.22							710.20	522.62	589.40	Bankrupt Res. 50%
198	Young Mfg. Co.	1,416.90			1,416.90							Trade Creditor
199	Zero, R. C.	750.00				750.00						Salesman
	#4	$ 59,618.27	$ 45.16	$ 10.00(a) 2,625.50	$ 24,260.90	$ 16,557.25	$12,395.50	$ 250.00	$ 1,210.20	$1,099.02	$1,209.90	
	3	49,286.70	239.80	522.50(a) 21,216.40	16,511.60	5,895.56	208.09	1,596.40	1,216.50		2,119.65	
	2	88,630.76	116.52	1,310.25(a) 46,691.25	21,319.25	5,916.25	392.77	2,816.25	626.59	4,446 95	5,111.20	
	1	97,105.95		496.20(a) 22,521.65	38,610.50	20,211.16	9,309.83	999.80	1,810.11	2,160.60	986.10	
		$294,641.68	$401.48	$ 2,338.95(a) $93,054.80	$100,702.25	$48,580.22	$22,306.19	$5,662.45	$4,863.40	$7,706.57	$9,426.85	
Customers' Credit Balances		401.48	J. E. #6	(a) Discounts Taken								
Balance per Ledger 12/31/28		$294,240.20										

ACCOUNTS RECEIVABLE (*Continued*)
CHARLES DARNER MANUFACTURING COMPANY, BOSTON, MASSACHUSETTS
DECEMBER 31, 1928

D1 (*Continued*)

Verification No.	Customer†	Trial Balance Dr.	Trial Balance Cr.	Realized to 1/31/29	December	November	October	July, Aug., Sept.	Apr., May, June	Jan., Feb., Mar.	Over One Year	Remarks
	As above	$294,641.68	....	$ 2,338.95(a) $93,054.80	$100,702.25	$48,580.22	$22,306.19	$5,662.45	$ 4,863.40	$7,706.57	$9,426.85	
	Less:											
	Accounts Receivable—Officer	1,250.00					500.00	250.00	500.00			
	Accounts Rec.—Warren Mfg. Co	21,120.30		220.10	9,554.30	7,190.65	4,155.25					
	Transportation Claim G	620.50	J. E. #6								620.50	
	Sales	25,400.00			10,650.00	7,850.00	6,900.00					
	Accounts Pay.—Trade Creditors	1,416.90			1,416.90							
	Advances to Salesmen	750.00				750.00						
		50,557.70*		220.10*	21,621.20*	15,790.65*	11,555.25*	250.00*	500.00*	....	620.50*	
	D	$244,083.98		$92,834.70	$ 79,081.05	$32,789.57	$10,750.94	$5,412.45	$ 4,363.40	$7,706.57	$8,806.35	

Summary—Age of Charges	
Realized to 1/31/29—Cash	$ 92,834.70
—Discount	2,338.95
	95,173.65*
December	79,081.05
November	32,789.57
October	10,750.94
July, Aug., Sept.	5,412.45
Apr., May, June	4,363.40
Jan., Feb., Mar.	7,706.57
Over One Year	8,806.35
Total Customers	$244,083.98

Goods on Consignment

Sales Value	$25,400.00	J. E. #6
Gross Profit 25 %	6,350.00	
Inventory Value	$19,050.00	

Verification
Independent trial balance and analysis of the age of unpaid balances.
200 confirmations mailed.
Accounts discussed with Treasurer.
December sales over $1,000.00 compared with Shipping Records.

A. Teppert

* Green.
† Note—Schedules, similar to that above, listing customers' accounts A-V, have been omitted.

FOREIGN DRAFTS DRAWN

CHARLES DARNER MANUFACTURING COMPANY, BOSTON, MASSACHUSETTS
DECEMBER 31, 1928

D2

Customer	Bank Held By	Draft No.	Date	Tenor	Amount	Dec. or Later	Nov.	Oct.	Prior Amount	Prior Date	How Verified
Bennett Co., L. L.	Third Nat'l. Bank, Boston	3,925	9/15/28	60	$ 982.40	....	$ 982.40	....	....	.....	Letter
Kirley and Vose..	" " " "	3,926	10/8/28	90	5,629.75	$ 5,629.75	....	....	....	.....	" 1/8/29 C B 108
Jones and Sons, Ltd..........	" " " "	3,927	10/9/28	120	8,116.95	8,116.95	....	....	....	.....	"
					14,729.10*						
Plant and Hall, Ltd...........	Nat'l. City Bank, New York	3,842	7/31/28	90	416.87	....	....	$ 416.87	....	.....	Letter
Pennick & Company..........	" " " " "	3,948	11/10/28	60	6,629.48	6,629.48	....	....	....	.....	" 1/10/29 C B 109
Wright, E. L.....	" " " " "	3,952	11/12/28	120	3,614.80	3,614.80	....	....	....	.....	"
					10,661.15*						
	Balance per Ledger 12/31/28			D	$25,390.25	$23,990.98	$ 982.40	$ 416.87			

* Green.

A. T.

Allowance for Doubtful Accounts and Discounts
Charles Darner Manufacturing Company,
Boston, Massachusetts
December 31, 1928

D3

Page No.	Customer	Total Account	Amount Considered Doubtful	Remarks
1	Adams Co., C. D.......	$ 2,610.50	$ 1,305.25	50%
1	Bartlett Mfg. Co.......	3,818.32	954.58	25
2	Cass, N. R............	6,215.90	1,864.77	30
2	Donaldson, F. F.......	496.28	496.28	100
2	Flint Machine Works...	10,216.80	4,086.72	40
3	Lincoln, A. C..........	6,296.25	499.16	old balance
3	Marston & Co., J......	3,366.60	3,029.94	90
4	Waitt, O. A...........	2,361.25	175.90	Allowed 1/9/29
4	Wright, A. A..........	3,910.55	400.50	Bad Debt 1/4/29
4	Yost, A. A............	1,822.22	911.11	50
			$13,724.21	
	Discounts taken to 1/31/29..........		2,338.95	
			$16,063.16	
	Allowance on Books.................		$15,000.00	
	Additional Allowance J. E. #6........		1,000.00	
	D		$16,000.00	

After discussion of the accounts with the treasurer it was mutually agreed that we should increase the Allowance to $16,000.

A. T.

Allowance for Doubtful Accounts
Charles Darner Manufacturing Company,
Boston, Massachusetts
For the Year Ended December 31, 1928 D3a

Balance January 1, 1928			$15,000.00
Additions			
Provision made January 1928	$ 750.00		
" " February "	750.00		
" " March "	750.00		
" " April "	750.00		
" " May "	750.00		
" " June "	750.00		
" " July "	750.00		
" " August "	750.00		
" " September "	750.00		
" " October "	750.00		
" " November "	750.00		
" " December "	544.88	$8,794.88	
Deductions			
4 Ralph Briggs Sons Co.	$1,463.20		
7 Hope Mfg. Co.	1,872.32		
5 Donald and Pratt, Inc.	542.80		
8 Howard & Co., Inc.	1,540.90		
6 Goodwear Mfg., Co.	972.67		
3 Bradley Bros., Inc.	1,505.55		
2 Am. Mfg. Co.	406.33		
1 H. M. Adams Co.	491.11	8,794.88	
Balance per Company Dec. 31, 1928			$15,000.00
J. E. #6			1,000.00
Per Balance Sheet 12/31/1928			D$16,000.00

F. S.

Realization of Accounts Previously Charged Off
Charles Darner Manufacturing Company, Boston, Massachusetts
For the Year Ended December 31, 1928 — D_{3b}

Hadley Mills	$112.50
Goodnow and Co., Inc.	96.70
Alberta Mills, Inc.	109.42
F. W. Webster Co.	500.00
Flint and Co.	78.82
	$897.44

F. S.

Trade Creditors Debit Balances
Charles Darner Manufacturing Company, Boston, Massachusetts
December 31, 1928 — D_4

Boston Machine Co.	$2,018.60	Motor ret'd. 12/20/28
Bakers Transportation Co.	192.40	Overpayment 12/17/28
	D$2,211.00	

Verification Included

Independent trial balance.

Discussion with Treasurer and other employees.

F. Seney.

Comparative Summary of Sales
Charles Darner Manufacturing Company, Boston, Massachusetts
December 31, 1928 — D_5

	1929	1928	1927
January	$176,240.90	$186,090.40	$167,400.94
December	....	201,345.67	195,457.89
November	....	196,424.90	200,765.43
October	....	210,123.45	208,156.78

Note: These amounts were taken from the sales books and compared with the General Ledger.

B. A. W.

INVENTORY SUMMARY
CHARLES DARNER MANUFACTURING COMPANY, BOSTON, MASSACHUSETTS
DECEMBER 31, 1928

E

	Per Company	Adjustments	Per S. S. & Co.	Dec. 31, 1927	Increase Decrease†
Raw Materials on Hand	J.E. #21 $ 197,420.83	E_1 $ 3,098.44†	$ 194,322.39	$ 192,806.53	$ 1,515.86
Raw Materials in Transit	E_3 13,321.40	AA J.E. #17 4,342.20	26,610.60	....	26,610.60
		CC_1 J.E. #19 8,947.00			
Work in Process	J.E. #21 E_4 124,231.06	E_1 217.76†	124,013.30	162,370.60	38,357.30†
Finished Goods	J.E. #21 E_{5a} 753,199.79	E_1 2,035.56†	751,164.23	813,099.95	61,935.72†
Manufacturing Supplies	J.E. #21 E_6 59,440.87	....	59,440.87	52,607.80	6,833.07
Waste	J.E. #21 E_7 3,161.75	....	3,161.75	4,806.72	1,644.97†
Goods on Consignment	....	E_8 J.E. #6 19,050.00	19,050.00	....	19,050.00
	1,150,775.70*	26,987.44*	1,177,763.14*	1,225,691.60*	47,928.46†
Advances on Raw Materials	....	CC J.E. #18 18,470.41	18,470.41	....	18,470.41
	$1,150,775.70	$45,457.85	$1,196,233.55	$1,225,691.60	$29,458.05†

* Green. † Red.

Tested physical quantities of Raw Materials and Finished Goods (E_{2b} and E_{5b})
Tested Prices:
Raw Materials—by inspection of invoices and outside quotations.E_{2a}
Process—by tests of Company's departmental costs.E_4
Finished Goods—by comparison with costs and sales in January 1929.E_{5a}
Supplies—by inspection of invoices.E_6
Waste—by inspection of sales contract and actual sales.E_7
Consignments—by correspondence and examination of book records.E_8
Advances—by inspection of book records and contracts.

Tested computations:
All extensions over $100.00. All footings for dollar values.

A. Teppert

INVENTORY EXCEPTIONS
CHARLES DARNER MANUFACTURING COMPANY, BOSTON, MASSACHUSETTS
DECEMBER 31, 1928

E1

Inventory Page	Description	Classification	Quantities		Prices		Extensions		S. S. & Co.	
			Co.	S. S. & Co.	Co.	S.S.&Co.	Co.	S. S. & Co.	Over	Under
	Computations									
16	#820 Blue	Raw	4,720 lb.	4,720 lb.	.45	.45	$ 2,214.00	$ 2,124.00	....	$ 90.00
19	#1016 "	"	1,995 "	1,995 "	.46	.46	91.80	918.00	$ 826.20	
116	Style #6024–7 Beams	Process	495 yd.	395 yd.	1.4915	1.4915	738.29	589.14	....	149.15
118	" #6021–6 Looms	"	230 "	230 "	1.6861	1.6861	556.41	387.80	....	168.61
120	Footing	"	....	....	......	......	2,998.62	3,098.62	100.00	
210	Style #6030–1	Finished	33,386 yd.	33,386 "	2.1302	2.1302	73,154.42	71,118.86	....	2,035.56
	Quantities									
26	#1430 Brown Yarn Lot 10160	Raw	16,873 lb.	14,873 lb.	.55	.55	9,280.15	8,180.15	....	1,100.00
28	# 944 Mixed " 112	"	322 "	4,322 "	.41	.41	132.02	1,772.02	1,640.00	
44	# 432 Gray " 7716	"	13,644 "	12,844 "	.45	.45	6,139.80	5,779.80	....	360.00
"	# " " " 9202	"	12,222 "	10,222 "	.45	.45	5,499.90	4,599.90	....	900.00
	Prices									
8	#1060	Raw	1,620 lb.	1,620 lb.	.90	.25	1,458.00	405.00	....	1,053.00
10	# 462	"	8,822 "	8,822 "	.46	.44	4,058.12	3,881.68	....	176.44
12	# 537	"	5,420 "	5,420 "	.48	.44	2,601.60	2,384.80	....	216.80
17	# 920	"	8,420 "	8,420 "	.54	.52	4,546.80	4,378.40	....	168.40
20	Knotted Yarn	"	10,000 "	10,000 "	.40	.25	4,000.00	2,500.00	....	1,500.00
									$2,566.20	$7,917.96
										2,566.20
										$5,351.76

J.E. #20

Inventory P & L 12/31/28	5,351.76	
Raw Materials		3,098.44
Work in Process		217.76
Finished Goods		2,035.56
		F.S.

Raw Materials

Charles Darner Manufacturing Company, Boston, Massachusetts
December 31, 1928

E2a

Inv. Page	Description	Quantity 1927	Quantity 1928	Value 1927	Value 1928	Unit Price 1927	Unit Price 1928	Market Price	Last Purchases Unit Price	Last Purchases Date	Last Purchases Quantity	Last Purchases Vendor
	Yarn on Cones											
2	#816 Blue..........	16,744 lb.	10,860 lb.	$ 9,209.20	$ 6,353.10	.55	.585	.60	.585	12/31/28	4,067 lb.	Atlas Yarn Co. New Bedford, Mass.
4	#1620 Gray.........	4,540 "	16,233 "	2,724.00	10,226.79	.60	.63	.63	.63	12/30/28	6,077 "	N. E. Mfg. Co.
4	#1632 Mixed........	15,852 "	14,728 "	10,779.36	10,309.60	.68	.70	.70	.70	12/15/28	5,530 "	Fall River, Mass.
5	#1430 Brown........	44,738 "	60,454 "	32,040.62	33,249.70	.53	.55	.55	.55	12/27/28	16,720 "	
6	#730 Mixed.........	47,237 "	62,530 "	19,839.54	28,138.50	.42	.45	.46	.45	12/27/28	30,442 "	
8	#1060 Gray Knit....	18,792 "	1,620 "	15,973.20	1,458.00	.85	.90	.25	.90*	(over one year old)		Abbot Yarn Co. Lawrence, Mass.
8	#944 Mixed........	60,403 "	72,430 "	22,953.14	29,696.31	.38	.41	.43	.41	11/15/28	27,220 "	
									.44	12/27/28	16,872 "	
10	#432 Gray..........	72,420 "	58,720 "	30,416.40	26,424.00	.42	.45	.46	.46	12/10/28	12,440 "	Fitchburg Yarn Mills Fitchburg, Mass.
10	#462...............	10,786 "	8,822 "	4,530.12	4,058.12	.42	.46	.48	.44*	12/2/28	2,162 "	
12	#537 Black.........	14,578 "	5,420 "	6,705.88	2,601.60	.46	.48	.44	.48*	7/3/28	1,620 "	
17	#920...............	......	8,420 "	....	4,546.80		.54	.52	.54*	12/6/28	1,437 "	New Bedford Yarn Co.
17	#922...............	......	6,440 "	....	3,542.00		.55	.56	.55	12/12/28	4,492 "	New Bedford, Mass.
	Knotted Yarn......	3,500 "	10,000 "	1,400.00	4,000.00	.40	.40	.25	*			
				Total Test	$164,604.52							
				Total Inventory	$197,420.83							
				Per cent	87 %							

* Adjusted by S.S. & Co.
See "Inventory Exceptions" E1.

F. S.

INVENTORY

Sheet No. 1 DECEMBER 31, 1928 Page 1
Department Stores
Location Stock Bldg.
Called by F. S. Entered by B. A. W.
S. S. & Co. E2b

Quantity	Pounds, Dozen Packages Etc.	Description	Company Count	Increase Decrease†
6,437	lbs.	#1620 Gray Lot 7761	6,437 lb.	0
9,796	"	" " " 7802	9,796 "	0
16,233*				
14,728	"	#1632 Mixed Lot 7620	14,728 "	0
14,728*				
14,873	"	#1430 Brown Lot 10160	16,873 "	2,000†
45,581	"	" " " 10208	45,581 "	0
60,454*				
18,784	"	#730 Mixed Lot 1673	18,784 "	0
10,720	"	" " " "	10,720 "	0
33,026	"	" " " "	33,026 "	0
62,530*				
4,322	"	#944 Mixed Lot 112	322 "	4,000
19,820	"	" " " 1806	19,820 "	0
26,481	"	" " " 1876	26,481 "	0
21,807	"	" " " 1927	21,807 "	0
72,430*				
12,844	"	#432 Gray Lot 7716	13,644 "	800†
10,222	"	" " " 9202	12,222 "	2,000†
26,786	"	" " " 8868	26,786 "	0
8,868	"	" " " 9109	8,868 "	0
58,720*				

* Figures in green.
† Figures in red.

F. S.

Raw Materials in Transit

Charles Darner Manufacturing Company,
Boston, Massachusetts
December 31, 1928

E3

Date of Invoice	Vendor	Description	Date Received	Amount
12/28/28	Fitchburg Yarn Mills....	10,090 lb. #432 at 46¢	1/3/29	$ 4,641.40
12/29/28	N. E. Mfg. Co..........	17,361 " #1430 at 50¢	1/2/29	8,680.00
		Balance Per Books		$13,321.40
Unentered Invoices:				
12/31/28	New Bedford Yarn Mills.	12,340 lb. #922 at 55¢	1/3/29	6,787.00
12/31/28	Abbot Yarn Company...	1,000 " #944 at 41¢	1/3/29	410.00
12/31/28	N. E. Mfg. Co..........	3,500 lb. #1430 at 50¢	1/3/29	1,750.00
				8,947.00*
Drafts against Letters of Credit				4,342.20
		Balance per S. S. & Co.	E	$26,610.60

* Green.

A. T.

Comparison—in Process Inventory

Charles Darner Manufacturing Company,
Boston, Massachusetts
December 31, 1928 and 1927

E4

	This Year			Last Year		
	Yards	Value	Ave. Cost	Yards	Value	Ave. Cost
Dressing Room....	6,641	$ 9,802.66	$1.4762	11,634	$ 16,702.83	$1.4357
Weaving Room....	4,927	8,217.45	1.6678	6,585	10,716.92	1.6273
Burling Room.....	5,584	10,163.30	1.8201	6,370	11,413.83	1.7916
Sewing Room.....	6,338	11,504.42	1.8147	8,205	14,806.40	1.8044
Fulling Room.....	7,844	14,730.84	1.8782	14,374	26,330.70	1.8318
Napping Room....	7,264	14,072.73	1.9374	10,334	19,703.82	1.9066
Shearing Room....	7,743	14,907.88	1.9253	8,736	16,660.40	1.9069
Brushing Room...	6,503	12,827.70	1.9725	12,479	24,108.53	1.9318
Pressing Room....	14,182	28,004.08	1.9746	11,299	21,927.17	1.9406
	67,026	$124,231.06	$1.8535	90,016	$162,370.60	$1.8038

B. A. W.

WORK IN PROCESS

CHARLES DARNER MANUFACTURING COMPANY, BOSTON, MASSACHUSETTS
DECEMBER 31, 1928

E4a

	Extent Processed	No. of Warps at 55 yd.	Material	Labor	Burden	Total	Inventory Quantity	Inventory Extension	S. S. & Co.
Yarn on Loom Beams:									
Style #6021–6	½ drawn	8 warps	$1.5075	$.0020	$.0023	$1.5118	440 yd.	$ 665.19	
" 6024–7	" "	9 "	1.4872	.0020	.0023	1.4915	395 "	738.29	$589.14 E1
Yarn on Looms:									
Style #6021–6	½ completed	6 "	1.5075	.0790	.0996	1.6861	230 "	556.41	387.80 E1
" 6024–7	completed	2 "	1.4872	.1540	.1946	1.8358	110 "	201.94	
Cloth in Burling Room:									
Style #6021–6	completed	14 bolts	1.5075	.1590	.2006	1.8671	770 "	1,437.67	
" 6024–7	"	4 "	1.4872	.1590	.2006	1.8468	220 "	406.30	
Cloth in Sewing Dept.:									
Style #6021–6	ready to sew	10 "	1.5075	.1590	.2006	1.8671	550 "	1,026.91	
" 6024–7	completed	6 "	1.4872	.1790	.2106	1.8768	330 "	619.34	
Cloth in Fulling Room:									
Style #6021–6	completed	21 "	1.5075	.2190	.2606	1.9871	1,155 "	2,295.10	
" 6024–7	ready to full	14 "	1.4872	.1790	.2106	1.8768	770 "	1,455.14	
Cloth in Napping Room:									
Style #6021–6	completed	8 "	1.5075	.2250	.2656	1.9981	440 "	879.16	
" 6024–7	ready to nap	9 "	1.4872	.2190	.2606	1.9668	495 "	973.57	
Cloth in Shearing Room:									
Style #6021–6	ready to shear	12 "	1.5075	.2250	.2656	1.9981	660 "	1,318.75	
" 6024–7	" " "	4 "	1.4872	.2190	.2606	1.9668	220 "	432.70	
Cloth in Brushing Room:									
Style #6021–6	ready to brush	16 "	1.5075	.2330	.2697	2.0102	880 "	1,768.98	
" 6024–7	completed	19 "	1.4872	.2350	.2722	1.9944	1,045 "	2,084.15	
Cloth in Pressing Room:									
Style #6021–6	ready to press	14 "	1.5075	.2350	.2722	2.0147	770 "	1,551.32	
" 6024–7	completed	10 "	1.4872	.2450	.2822	2.0144	550 "	1,107.92	

This illustrates two styles only; in all we checked approximately 50 % of the Process Inventory to the cost records.

B. A. Watt.

E4b

Charles Darner Manufacturing Company,
Boston, Massachusetts
Yarn Costs

Style 6021-6:	
2 lb. #730 at .45	.9000
½ " #816 at .585	.2925
½ " #1620 at .63	.3150
	1.5075 Yarn cost per yd. of cloth

Work in Process—Costs
For the Year Ended December 31, 1928

	Putting Yarn on Warps	Weaving	Burling	Sewing	Fulling	Napping	Shearing	Brushing	Pressing	Total
Labor										
Year ended 12/31/28	$3,923.27	$138,895.34	$4,595.01	$18,700.76	$37,232.68	$5,584.90	$7,470.63	$1,961.63	$9,506.32	$227,870.54
Production for year 930,817 yd.										
Ave. departmental costs	.0042	.1495	.0049	.0200	.0400	.0059	.0082	.0021	.0100	.2448
Burden Distributed:										
Year ended 12/31/28	4,381.76	177,855.26	5,584.90	9,408.17	46,540.75	4,595.01	3,816.35	2,387.04	9,406.86	263,976.10
Production for year 930,817 yd.										
Ave. departmental costs	.0047	.1915	.0060	.0100	.0499	.0049	.0041	.0025	.0100	.2836

E$_{4b}$ (*Continued*)

Company's Method of Costing Cloth

Style 6021-6	Raw Materials	Direct Labor	Burden	Accumulated Total
	$1.5075	......	......	$1.5075
Putting yarn on warps........		$.0040	$.0046	.0086
	1.5075*	.0040*	.0046*	1.5161*
Weaving....................		.1500	.1900	.3400
	1.5075*	.1540*	.1946*	1.8561*
Burling....................		.0050	.0060	.0110
	1.5075*	.1590*	.2006*	1.8671*
Sewing....................		.0200	.0100	.0300
	1.5075*	.1790*	.2106*	1.8971*
Fulling....................		.0400	.0500	.0900
	1.5075*	.2190*	.2606*	1.9871*
Napping....................		.0060	.0050	.0110
	1.5075*	.2250*	.2656*	1.9981*
Shearing....................		.0080	.0041	.0121
	1.5075*	.2330*	.2697*	2.0102*
Brushing....................		.0020	.0025	.0045
	1.5075*	.2350*	.2722*	2.0147*
Pressing....................		.0100	.0100	.0200
	$1.5075	$.2450	$.2822	$2.0347

* Green.

B. A. W.

Production Summary
Charles Darner Manufacturing Company, Boston, Massachusetts
For the Year Ended December 31, 1928

E$_{4c}$

Style	Yards
6021-6	64,872
6021-7	50,430
6023-6	98,428
6024-2	76,832
6024-3	112,972
6024-6	148,832
6024-7	139,187
6030-1	80,320
6030-4	32,432
6030-5	13,432
6030-6	36,854
6072-2	18,672
6072-3	26,840
6072-4	30,714
	930,817

F. S.

FINISHED GOODS PRICE TEST

CHARLES DARNER MANUFACTURING COMPANY, BOSTON, MASSACHUSETTS

DECEMBER 31, 1928

E5a

Inventory Page	Description	Inventory per Company					Mark-up		Actual Sales		Remarks
		Quantity	Total	Unit Price	Cost	Net Selling Price	Dollars	Per Cent	Date	Quantity	
201	Style #6021–6	46,192 yd.	$ 94,186.86	2.0347	2.0347	2.45	.4153	17 %	1/6/29	15,000 yd.	S.I. 146
201	" #6021–7	70,153 "	134,055.36	1.9109	1.9109	2.45	.5391	22	1/4/29	20,000 "	" " 130
203	" #6023–6	32,181 "	56,667.52	1.7609	1.7609	2.10	.3391	19	1/10/29	5,000 "	" " 170
204	" #6024–2	26,013 "	52,647.71	2.0239	2.0239	2.45	.4261	17	1/16/29	20,000 "	" " 190
204	" #6024–3	80,476 "	165,418.42	2.0555	2.0555	2.50	.4445	22	1/24/29	4,500 "	" " 226
204	" #6024–6	40,002 "	76,463.82	1.9115	1.9115	2.30	.3885	20	1/17/29	10,000 "	" " 176
205	" #6024–7	18,172 "	36,605.68	2.0144	2.0144	2.35	.3356	17	1/18/29	5,000 "	" " 183
210	" #6030–1	33,386 "	73,154.42*	2.1302	2.1302	2.60	.4698	22	1/19/29	16,000 "	" " 200
	Total Tested		$689,199.79								
	Total Inventory		$753,199.79								
	Per cent Tested		91.50 %								

* Extension should be $71,118.86 E1.

B. A. W.

INVENTORY

DECEMBER 31, 1928

Sheet No. 2 Page 2
Department Shipping
Location Shipping Room
Called by F. S. Entered by B. A. W.
S. S. & Co. E_{5b}

Quantity	Pounds, Dozen Packages, Etc.	Description	Company Count	Increase Decrease*
		Finished Goods		
46,192	yd.	Style #6021-6	46,192	0
70,153	"	" #6021-7	70,153	0
32,181	"	" #6023-6	32,181	0
26,013	"	" #6024-2	26,013	0
80,476	"	" #6024-3	80,476	0
40,002	"	" #6024-6	40,002	0
18,172	"	" #6024-7	18,172	0
33,386	"	" #6030-1	33,386	0

F. S.

Manufacturing Supplies

Charles Darner Manufacturing Company, Boston, Massachusetts

December 31, 1928

E6

Inventory Page	Description	Inventory per Company			Last Purchase Price	Market	Vendor	Invoice		Source of Market
		Quantity	Total	Unit Price				Date	Quantity	
	Finishing Supplies:									
126	Finishing Oil........	1,760 gal.	$1,100.00	.62½ gal.	$ .62½	$ .65	Super Oil Co.	11/20/28	2,600 gal.	Letter
"	H. H. Soap..........	62 bbl.	669.60	10.80 bbl.	10.80	10.90	Dexter Oil Co.	7/23/28	100 bbl.	1/11/29 invoice
	Shipping Supplies:									
126	Burlap 18 Bales 9 × 9	54,000 yd.	6,075.00	.11¼ yd.	.11¼	.11¼	Lowell Mfg. Co.	10/18/28	72,000 yd.	Letter
"	Kraft Paper 60 × 72	15,300 pc.	956.24	.06¼ yd.	.06¼	.06¼	International Paper Co.	8/3/28	20,000 pc.	1/28/29 invoice
"	Cores Estimated		5,000.00	Nominal Valuation—No change during last three years.						
	Coal:									
127	Bituminous..........	520 ton	3,317.60	6.38 ton	6.38	6.38	Boston Coal Co.	12/3/28	916 ton	Telephone
	Roll Covering:									
127	Roll Covering........	15 pc.	900.00	60.00 each	60.00	60.00	Standard Roll Cov. Co.	10/17/28	20 pc.	1/5/29 invoice
		Total Tested	18,018.44							
		Total Inventory	59,440.87							
		Per cent Tested	30.30 %							

B. A. W.

WASTE INVENTORY
CHARLES DARNER MANUFACTURING COMPANY,
BOSTON, MASSACHUSETTS
DECEMBER 31, 1928 E7

Yarn Waste 12,647 lb. at 25¢ lb. = $3,161.75

Contract

Examined agreement with the Johnson Waste Company, contracting for the entire quantity of waste produced for the 6 months ended June 30, 1929 at the price of 27¢ per lb. The sales book subsequent to 12/31/28 was examined and the waste prices found to be in agreement with the prices quoted in the aforementioned contract.

A. TEPPERT

GOODS ON CONSIGNMENT
CHARLES DARNER MANUFACTURING COMPANY, BOSTON, MASSACHUSETTS
DECEMBER 31, 1928

E8

Date Shipped	Consignee	Description	Quantity	Cost	Extension	Remarks	How Verified
10/28/28	H. L. Adams, Inc., Chicago	Style #6021–6	1,000 yd.	$2.0347	$ 2,034.70	Fall Line	Letter & Book Records
11/30/28	Bloom & Co., New York	" #6024–6	1,500 "	1.9115	2,867.25	Spring Line	" " " "
"	" " " " "	" #6024–7	2,500 "	2.0144	5,036.00	" "	" " " "
12/15/28	Cooper Cloth Co., New York	" #6030–1	1,800 "	2.1302	3,834.36	" "	" " " "
"	" " " " "	" #6024–3	2,567½ "	2.0555	5,277.69	" "	" " " "
					19,050.00		
					J.E. #6		

B. A. W.

Unfilled Sales and Purchase Contracts
Charles Darner Manufacturing Company, Boston, Massachusetts
December 31, 1928

E9

Customer or Vendor	Description of Materials	Date of Contract	Contract Number	Quantity Ordered	Quantity Delivered	Balance to Deliver	Net Contract Price	Net Selling Price or Market	Cost	Per cent Gross Profit
Sales										
Haskell Clo. Co.	Style #6021–6	11/15/28	11806 A	15,000 yd.	.... yd.	15,000 yd.	$2.45	$2.45	$2.0347	17 %
" " "	" #6021–7	12/10/28	11905 A	20,000 "	4,620 "	15,380 "	2.45	2.45	1.9109	22
" " "	" #6024–2	10/28/28	10707 A	20,000 "	.... "	20,000 "	2.45	2.45	2.0239	17
" " "	" #6024–3	"	10708 A	25,000 "	.... "	25,000 "	2.50	2.50	2.0555	22
" " "	" #6024–6	"	10706 A	15,000 "	2,430 "	12,570 "	2.30	2.30	1.9115	20
Warren Mfg. Co.	" #6024–7	11/3/28	10902 A	25,000 "	.... "	25,000 "	2.35	2.35	2.0144	17
" " "	" #6030–1	11/10/28	11507 A	20,000 "	.... "	20,000 "	2.60	2.60	2.1302	22
" " "	" #6024–6	10/25/28	10605 A	30,000 "	16,780 "	13,220 "	2.30	2.30	1.9115	20
" " "	" #6024–3	11/10/28	11508 A	15,000 "	.... "	15,000 "	2.50	2.50	2.0555	22
Purchase										
Atlas Yarn Co.	#816 Blue	11/30/28	9,612	200,000 lb.	121,740 lb.	78,260 lb.	.585	.60		
N. E. Mfg. Co.	#1620 Gray	11/15/28	9,602	200,000 "	144,820 "	55,180 "	.63	.63		
" " " "	#1632 Mixed	12/3/28	9,614	150,000 "	126,230 "	23,770 "	.70	.70		
Abbot Yarn Co.	#730 Mixed	12/16/28	9,615	125,000 "	112,800 "	12,200 "	.45	.45		
Fitchburg Yarn Mills	#432 Gray	11/28/28	9,610	75,000 "	....	75,000 "	.46	.46		

F. S.

Life Insurance
Charles Darner Manufacturing Company, Boston, Massachusetts
December 31, 1928

F

Policy No.	Company	Insured	Kind of Insurance	Date of Policy	Amount	Cash Surrender Value				How Verified
						Anniversary after 12/31/28	6 % Discount		12/31/28	
							Time	Amount		
4678982	New York Life Ins. Co.	Pres. Charles Darner	20 yr. end.	1/18/18	$ 5,000.00	$ 2,250 00	18 da.	$ 6.75	$ 2,243.25	Examination and Correspondence
4689724	" " " " "	" " "	" " "	6/20/18	5,000.00	2,200.00	5 mo. 20 "	62.22	2,137.78	
3434887	Equitable Life Ass. Soc.	" " "	20 pay. life	5/17/24	15,000.00	850.00	4 " 17 "	19.45	830.55	" "
3240362	" " " "	" " "	straight life	4/30/28	50,000.00	....			....	
332684	Conn. Genl. Life	Treas. Peter Cranston	10 yr. term	8/25/27	20,000.00	....			....	" "
1642302	Aetna Life	" " "	" " "	4/30/23	5,000.00	....			....	" "
340762	Conn. Genl. Life	" " "	" " "	5/16/26	10,000.00	....			....	" "
274276	Federal Mutual Ins. Co.	V. Pres. R. M. Darner	20 pay. life	8/11/25	25,000.00	4,050.00	7 mo. 11 da.	149.18	3,900.82	" "
275740	" " " "	" " " "	" " "	"	10,000.00	1,650.00	7 " 11 da.	60.77	1,589.23	" "
331747	" " " "	" " " "	straight life	8/1/27	10,000.00	....			....	
					$155,000.00	$11,000.00	....	$298.37	$10,701.63	

LIFE INSURANCE (*Continued*)
CHARLES DARNER MANUFACTURING COMPANY, BOSTON, MASSACHUSETTS
DECEMBER 31, 1928

F (*Continued*)

Policy No.	Premium Period	Date Paid	Period Covered	Amount	Total Paid for Year	Dividends Received	Deduct Loan: Date	Deduct Loan: Amount	Deduct Loan: Acc. Interest	
4678982	quarterly	10/1/28	10/18/28–1/18/29	$ 56.00	$ 224.00	......		....	......	
4689724	"	12/15/28	12/20/28–3/20/29	56.00	224.00	......		....	......	
3434887	"	11/10/28	11/17/28–2/17/29	157.50	630.00	......		....	......	
3240362	annually	5/15/28	4/30/28–4/30/29	1,750.00	1,750.00	......		....	......	
332684	quarterly	11/15/28	11/25/28–2/25/29	100.00	400.00	......		....	......	
1642302	"	"	" "	27.00	108.00	......		....	......	
340762	"	11/10/28	11/16/28–2/16/29	52.50	210.00	......		....	......	
274276	quarterly	11/1/28	11/11/28–2/11/29	250.00	1,000.00	$ 200.00	9/1/28	$3,241.00	$ 75.62	
275740	semi-ann.	8/1/28	8/11/28–2/11/29	100.00	400.00	80.00	"	1,296.00	30.24	
331747	annually	7/15/28	8/1/28–8/1/29	480.00	480.00	96.00		....	......	
					$5,426.00	$ 376.00		$4,537.00	$105.86	$4,642.86
					376.00					
				Net Premiums	$5,050.00					

Net Cash Surrender Value per S. S. & Co.	6,058.77		
" " " " " Books	5,300.00		
	758.77		

Jan. 29, 1929

Received of Representative of Seymour, Sibley & Co. Life Insurance Policies as listed above, presented to him for examination.

Peter Cranston

J.E. #12

Cash Surrender Value—Life Insurance		$10,701.63	
Interest Paid		105.86	
Loan on Life Insurance			4,537.00
Accrued Interest			105.86
Cash Value per Books			5,300.00
Increase in Cash Value—Life Insurance			864.63
		$10,807.49	$10,807.49

F. S.

VERIFICATION OF CASH SURRENDER VALUE—INSURANCE

New York Life Insurance Co.
60 State St.
Boston, Mass.

Gentlemen: F_1

For the purpose of our regular audit will you kindly furnish our auditors, Seymour, Sibley & Co., 50 Federal St., Boston, Mass., with the following information concerning Life Insurance Policies #4678982 and #4689724 as of Dec. 31, 1928:

Amount of Coverage
Beneficiary
Amount of Loans
Cash Surrender Value

We enclose a stamped envelope for your convenience.

Very truly yours,

CHARLES DARNER MFG. CO.
By PETER CRANSTON

M. R.

SUMMARY OF OTHER ASSETS
CHARLES DARNER MANUFACTURING COMPANY,
BOSTON, MASSACHUSETTS
DECEMBER 31, 1928 G

Investment in Outside Real Estate: G_1				
Cost			$35,800.00	
Less: Allowance for Depreciation			457.45	$35,342.55
Account Receivable—Warren Mfg. Co.: D_1				
Advance to Affiliate				21,120.30
Miscellaneous Notes—Accounts, etc.:				
Accounts Receivable—Officers and Employees		G_2	$ 6,093.25	
Note Receivable—Officer	C1,500.00			
Accrued Interest	25.00		1,525.00	
Transportation Claims		D_1	620.50	
Miscellaneous Investment—				
West Newton Knitting Mills		B	1.00	8,239.75
Mortgages Receivable: G_3				
Mortgages			$ 3,000.00	
Accrued Interest			12.25	3,012.25
Note Receivable—Customer: C				
Due subsequent to Dec. 31, 1929			$ 1,750.00	
Accrued Interest			43.75	1,793.75
Total per Balance Sheet				$69,508.60

A. T.

INVESTMENTS IN OUTSIDE REAL ESTATE

CHARLES DARNER MANUFACTURING COMPANY, BOSTON, MASSACHUSETTS
DECEMBER 31, 1928

G1

Invoice Date	Vendor	Reference	Amount	Description
6/15/28	Henry G. Wilton	600–48	$16,800.00	2 Dwelling 16–18 Pearl St., Malden, Mass. Middlesex County. Recorded Book 506 Page 304—
9/15/28	" " "	900–96	19,000.00	2 Dwelling 20–22 Pearl St., Malden, Mass. Middlesex County. Recorded Book 596 Page 76—
			G $35,800.00	

Note:
No division was made in the Deed for the individual costs of land and buildings. Deed examined by A. Teppert.

Basis for Depreciation	Assessed Values	%	% Applied to Cost	Depreciation Rate	Time	Amount
16–18 Pearl Street						
Land.......	$ 2,160.00	20	$ 3,360.00	...	....	.....
Building....	8,640.00	80	13,440.00	4 %	6½ mo.	$291.20
	$10,800.00	100	$16,800.00			
20–22 Pearl Street						
Land.......	$ 3,000.00	25	$ 4,750.00	...	....	.....
Building....	9,000.00	75	14,250.00	4 %	3½ mo.	166.25
	$12,000.00	100	$19,000.00			$457.45
						J.E. #23

B. A. W.

Jan. 29, 1929
Received of Representative of Seymour, Sibley & Co. the Deeds listed above and presented to him for his examination.

Peter Cranston.

ACCOUNTS RECEIVABLE—OFFICERS AND EMPLOYEES

CHARLES DARNER MANUFACTURING COMPANY, BOSTON, MASSACHUSETTS
DECEMBER 31, 1928

G2

Name	Origination	Balance per Books	Adjustments	Balance per S. S. & Co.	Remarks	How Verified
Advances to Salesmen:						
L. C. Downs..........	Auto $1,000	$1,000.00		$1,000.00	Still employed at 2/18/29—Paid $100.00 on account in January 1929	Letter & analysis of account
L. G. Sampson....EE2	Travel Advances	3,500.00	$2,237.55* J.E.#22	1,262.45	Commission salesmen	Analysis of book account and computation
Loans to Employees:						
Ralph Goodhue....EE2	Personal Advance	1,500.00		1,500.00	Still employed at 2/18/29—Paid $50.00 on account in January 1929	Letter & analysis of account
		6,000.00†	2,237.55*	3,762.45†		
S. S. & Co. Adjustments						
From Accounts Receivable: D1						
F. G. Walsh—Officer...		J.E.#6	1,250.00	1,250.00		
R. C. Zero—Salesman..		J.E.#6	750.00	750.00		
From Petty Cash Count:						
L. C. Downs } A3b2		J.E.#3	74.50*	74.50* }	December traveling expenses	
L. G. Sampson } A3b2		J.E.#3	68.32*	68.32* }		
B. Brown } A3		J.E.#2	125.00	125.00		
H. Thomas } A3		J.E.#2	40.00	40.00		
C. A. Austin } A3		J.E.#2	25.00	25.00		
L. B. Small } A3a1		J.E.#2	24.00	24.00		
R. H. Macomber } A3a1		J.E.#2	9.62	9.62		
From Bank Reconciliation:						
Ralph Goodhue......A1a		J.E.#1	250.00	250.00		
		$6,000.00	$ 93.25	$6,093.25		

B. A.W.

* Red.
† Green.

MORTGAGES RECEIVABLE

CHARLES DARNER MANUFACTURING COMPANY, BOSTON, MASSACHUSETTS
DECEMBER 31, 1928

G3

Date of Note	Maker	Property	Int. Rate	Due Date	Amount	Interest Paid To	Accrued Time	Interest Amount	Verification, Etc.
First Mortgage: 6/10/28	Herbert B. & Maud I. Burrell	10 Pearl St., Malden, Mass.	6 %	Demand	$1,500.00	12/10/28	21 days	$ 5.25	Examination and communication. Recorded Book 2406 Page 537—Middlesex County
Second Mortgage: 6/10/28	Herbert B. & Maud I. Burrell	10 Pearl St., Malden, Mass.	8 %	$40. per mo.	1,500.00	12/10/28	21 days	7.00	Examination and communication. Recorded Book 2406 Page 559—Middlesex County Originally $1740.00; payments regular
				G	$3,000.00			$12.25	

Note: Company holds the following fire insurance policies payable to the Company as their interests may appear:

Company	*Expiration Date*	*Amount*
Citizens Fire Insurance Co.	6/10/31	$4,000.00
Federal " " "	6/10/31	2,000.00
		$6,000.00

J.E. #13

Accrued Interest—Mortgages Rec.	$12.25	
Interest Earned		$12.25

Jan. 29, 1929
Received of Representative of Seymour, Sibley & Co. all Mortgages, Notes and Insurance Policies applicable thereto, listed above, and for which I am accountable to the Charles Darner Mfg. Co.

Peter Cranston
B. A. W.

Additions to Permanent Assets
Charles Darner Manufacturing Company, Boston, Massachusetts
For the year ended December 31, 1928

H

Date of Invoice	Vendor	Reference	Amount		Description
	Land				
	Balance Dec. 31, 1928 (No Changes)			$ 99,510.00	
	Buildings				
12/31/27	Balance			1,041,762.86	
	Additions				
5/11/28	Central Supply Co.	Vo. 597–3	$1,220.00		Heating Equipment—new storehouse
6/10/28	Cross Construction Co.	599–2	7,296.11		Final payment—construction new warehouse
7/16/28	General Electric Co.	620–10	97.20		Switches, relays, etc.
11/11/28	Central Supply Co.	1002–4	124.13		Valves, nipples, "
11/17/28	Franklin Process Co. (Transfer)	1010–6	8,690.00		4 Dyeing Machines
12/10/28	Tr. from Work in Process	J 49	1,296.40	18,723.84	Material $480.72—Labor $355.72—Burden $459.96. Building bins.
12/31/28	Balance per Books			$1,060,486.70	
	Adjustment				
	Tr. to Machinery and Equipment J.E. #7			8,690.00*	
	Balance per S. S. & Co. 12/31/28			$1,051,796.70	
	Machinery and Equipment				
12/31/27	Balance			$1,396,687.76	
	Additions				
3/26/28	Curtis and Marble Mach. Co.	Vo. 430–22	$1,248.00		6 Inspecting Tables @ $208 each
4/15/28	Economy Electric Co.	520–11	36.70		Installing new motors for Tables
4/17/28	Weld and Weld	518–8	336.00		" " Tables
4/29/28	Boston and Albany	440–16	28.94		Freight on " "
6/15/28	Washburn Machine Co.	600–48	486.00	2,135.64	84 Stands for thread guides and compressor rods
				$1,398,823.40	
	Deductions				
5/15/28	Curtis and Marble Mach. Co. H1	570–10	$ 60.00		Allowance on 3 old Inspecting Tables
5/18/28	Weld and Weld	572–16	17.80		" " labor installing new Tables
8/13/28	Dunn Scrap Co. H1	S 12445	120.00	197.80	6 Looms scrapped
	Balance per Books			$1,398,625.60	
	Adjustments				
	Tr. from Buildings	J.E. #7	$8,690.00		
	Balance-Inspecting Tables H1	J.E. #8	610.00*		Eliminating Inspecting Tables traded—cost $670.00
	Balance-Looms Scrapped H1	J.E. #8	2,280.00*	5,800.00	" Looms scrapped " $2,400.00
	Balance per S. S. & Co. 12/31/28			$1,404,425.60	

* Red.

ADDITIONS TO PERMANENT ASSETS (*Continued*)
CHARLES DARNER MANUFACTURING COMPANY, BOSTON, MASSACHUSETTS
FOR THE YEAR ENDED DECEMBER 31, 1928 H (*Continued*)

Date of Invoice	Vendor	Reference	Amount		Description
	Autos and Trucks				
12/31/27	Balance				
	Packard Truck		$5,023.75		
	Ford Truck		611.87		
	Packard Phaeton		4,210.50	$ 9,846.12	
	Additions				
7/17/28	Brighton Chrysler Co.	Vo. 630–11	1,825.00		New Chrysler Sedan
10/30/28	Dodge Motor Co.	910–17	1,243.18	3,068.18	" 1½ ton Dodge Truck
				$12,914.30	
	Deductions				
10/30/28	Dodge Motor Co.	910–18		70.00	Allowance on Ford Truck traded in
12/31/28	Balance per Books			$12,844.30	
	Adjustment H1	J.E.#8		541.87*	Eliminating Ford Truck-cost $611.87
	Balance per S. S. & Co. 12/31/28			$12,302.43	
	Office Furniture and Fixtures				
12/31/27	Balance			$73,370.80	
	Additions				
1/3/28	Office Appliance Co.	Vo. 220–19	$ 300.00		New Letter Files
3/18/28	Burroughs Adding Mach. Co.	410–20	275.00		1 Adding Machine #A 667788 cost $300, allowance $25
5/3/28	Office Appliance Co.	550–8	155.00		2 Desks
	" " "	550–9	44.00	774.00	2 Chairs
12/31/28	Balance per Books			$74,144.80	
	Adjustment H1	J.E.#8		225.00*	Eliminating Adding Machine-cost $250.00
	Balance per S. S. & Co.	12/31/28		$73,919.80	

* Red.

A. T.

Profit or Loss on Sale of Capital Assets
Charles Darner Manufacturing Company, Boston, Massachusetts
For the year ended December 31, 1928

H1

	Selling Price	Cost	Depreciation Charged to Operations	Profit Loss*
3 Inspecting Tables	$ 60.00	$ 670.00	$ 281.40	$ 328.60*
6% Dep. 7 yrs.				
6 Looms Scrapped	120.00	2,400.00	2,160.00	120.00*
6% Dep. 15 yrs.				
Ford Truck	70.00	611.87	611.87	70.00
Adding Machine	25.00	250.00	200.00	25.00*
	$275.00	$3,931.87	$3,253.27	$ 403.60*
J.E.#8				
Allowance for Depreciation—Machy. and Eq.			$2,441.40	
" " " —Autos and Trucks			611.87	
" " " —Fur. and Fix.			200.00	
Loss on Sale of Capital Assets			403.60	
Machinery and Equipment				$2,890.00
Autos and Trucks				541.87
Office Furniture and Fixtures				225.00
			$3,656.87	$3,656.87

* Red.

A. T.

Analysis—Allowances for Depreciation
Charles Darner Manufacturing Company, Boston, Massachusetts
For year ended December 31, 1928

H2

			Reference	Balance Jan. 1, 1928	Additional Depreciation	Deductions	Balance per Books Dec. 31, 1928	Adjustments	Balance per S.S. & Co. Dec. 31, 1928
Buildings:				$460,049.01					
Depreciation charged off by Company for year		$ 20,861.19			$20,861.19				
2 % Depreciation on Balance of $1,041,762.86 at 1/1/28		20,835.26	J.E. #9					$ 25.93*	
				$460,049.01	$20,861.19		$480,910.20	$ 25 93*	$480,884.27
Machinery and Equipment:				$393,655.85					
Depreciation charged off by Company for year					$77,744.25				
Balance Asset Account 1/1/28		$1,396,687.76							
Less: Additions to 1/1/28 fully depreciated	$300,222.60								
Assets sold or scrapped during 1928	3,070.00								
Additions for year ended 12/31/28	18,972.60	322,265.20							
		$1,074,422.56							
7 % Depreciation on Balance of $1,074,422.56	$ 75,209.58								
2 % " " 1928 additions of $18,972.60	379.45$	75,589.03							
" per Books (as above)		77,744.25	J.E. #9					$2,155.22*	
Eliminating Depreciation on Assets sold or scrapped			J.E. #8H1					2,441.40*	
				$393,655.85	$77,744.25		$471,400.10	$4,596.62*	$466,803.48
Autos and Trucks: Date Purchased									
Packard Truck 9/30/25 Cost $5,023.75 for 12 mos. at 25 %		$ 1,255.94	J.E. #9	$ 2,999.73	$ 1,100.00		$ 4,099.73	$ 155.94	$ 4,255.67
Ford Truck 4/30/23 " 611.87 fully depreciated			J.E. #8H1	611.87			611.87	611.87*	
Packard Phaeton 7/30/27 " 4,210.50 for 12 mos. at 25 %		1,052.63	J.E. #9	438.60	1,050.00		1,488.60	2.63	1,491.23
Chrysler Sedan 7/17/28 " 1,825.00 " 5½ " at 25 %		209.22	J.E. #9		200.00		200.00	9.22	209.22
Dodge Truck 10/30/28 " 1,243.18 " 2 " at 25 %		45.96	J.E. #9		50.00		50.00	4.04*	45.96
		$ 2,563.75		$ 4,050.20	$ 2,400.00		$ 6,450.20	$ 448.12*	$ 6,002.08

* Red.

ANALYSIS—ALLOWANCES FOR DEPRECIATION (*Continued*)
CHARLES DARNER MANUFACTURING COMPANY, BOSTON, MASSACHUSETTS
FOR YEAR ENDED DECEMBER 31, 1928

H_2 (*Continued*)

			Reference	Balance Jan. 1, 1928	Additional Depreciation	Deductions	Balance per Books Dec. 31, 1928	Adjustments	Balance per S.S.&Co. Dec. 31, 1928
Office Furniture and Fixtures:				$ 26,778.29					
Depreciation charged off by Company for year					$ 6,318.41				
Balance Asset Account 1/1/28		$ 73,370.80							
Less: Additions to 12/31/27—fully depreciated	$ 18,345.20								
Cost of assets sold	250.00	18,595.20							
		$ 54,775.60							
Depreciation charged off per company		$ 6,318.41							
Depreciation of 10 % on $54,775.60-		5,477.56	J.E. #9					$ 840.85*	
Eliminating Depreciation on adding machine sold			J.E. #8H_1					200.00*	
				$ 26,778.29	$ 6,318.41		$ 33,096.70	$1,040.85*	$ 32,055.85

* Red.

F. S.

ANALYSIS OF PATENTS
CHARLES DARNER MANUFACTURING COMPANY,
BOSTON, MASSACHUSETTS
FOR THE YEAR ENDED DECEMBER 31, 1928 I

Date	Description	Reference	Amount
1/1/28	Balance per Books	....	$44,000.00
	Additions		
12/31/28	Emery, Booth, Malcolm & Varney	Vo. 12–106	
	Legal Services to date in connection Box Patent $5,700.00—Annual Retainer $300.00	....	6,000.00
12/31/28	Balance per Books	....	$50,000.00
	Charging annual retainer to expense	J.E.#14	300.00*
	Balance per S. S. & Co.	....	$49,700.00
	Allowance for Amortization		
1/1/28	Balance per Books	....	$31,049.32
	Additions		
12/31/28	Amortization per Company	Vo. 63	3,941.18
12/31/28	Balance per Books	....	$34,990.50
	Adjusting Amortization to following basis:		
	$44,000—1/17 $2,588.24		
	$ 5,700—1/34 167.64 $2,755.88		
	Per books 3,941.18	J.E.#15	1,185.30
	Balance per S. S. & Co.	....	$33,805.20
	Net Amortized Value	....	$15,894.80

* Red.

Verification Included

Analysis of ledger accounts
Inspection of invoices
Computation of amortizations.

B. A. W.

Analysis of Goodwill
Charles Darner Manufacturing Company,
Boston, Massachusetts
December 31, 1928

J

12/31/27	Balance per books			$100,000
12/31/28	Balance per Books			$100,000
12/31/25	Balance		0	
6/15/26	Capital stock of a par value of $200,000 was issued to stockholders of John Doyle, Inc., in consideration of the following assets and liabilities taken over as at the close of business 5/31/26			
	Assets:			
	Accounts Receivable	$35,139		
	Merchandise Inventories	40,019		
	Land	14,631		
	Building	40,000		
	Machinery	60,000	$189,789	
	Liabilities:			
	Notes Payable—Banks	$50,000		
	Accounts Payable	39,789	89,789	
	Net Value		$100,000	
	Stock Payment		200,000	
	Excess of amount paid over book value of assets acquired on goodwill. Balance per books and S. S. & Co., 12/31/28			$100,000

Verification Included
Analysis of Account
Examination of Contract

January 29, 1929

Received of representative of Seymour, Sibley & Co. the contract with John Doyle, Inc., dated June 15, 1926.

Peter Cranston
B. A. W.

Unamortized Bond Discount
Charles Darner Manufacturing Company, Boston, Massachusetts
December 31, 1928

K1

Balance per Books, 12/31/27 and 12/31/28			$61,457.18	
Providing for amortization as follows:				
7/12 of amortization applicable to bonds outstanding prior to 8/1/28	$20,502.77 × 7/12	$11,959.95		
5/12 of amortization applicable to bonds outstanding subsequent to 8/1/28	$13,502.78 × 5/12	5,626.15	17,586.10	J.E.#26
Balance per S. S. & Co.			$43,871.08	

Verification Included

Examination of Bond Discount Master Schedule Computation.

B. A. W.

Organization Expense—Deferred
Charles Darner Manufacturing Company, Boston, Massachusetts
December 31, 1928

K2

Jones, Allen & Pratt—legal services at incorporation		$ 3,000.00
Adams, Cushing & Foster, Inc.—printing stock certificates, etc.		750.00
Stock issued as bonus to the Symmes Corporation for selling stock		100,000.00
		$103,750.00
Less: 20% charge off each year		
1926	$20,750.00	
1927	20,750.00	
1928	20,750.00	62,250.00
Balance per Books and S. S. & Co. 12/31/28		$ 41,500.00

Note: Company incorporated Jan. 1, 1926.

Verification Included

Inspection of prior years' working papers and ledger account.

B. A. W.

OPERATING SUPPLIES

CHARLES DARNER MANUFACTURING COMPANY, BOSTON, MASSACHUSETTS
DECEMBER 31, 1928

K8

Inventory Page	Description	Inventory per Company		Unit Cost	Market Price	Vendor	Date
		Quantity	Value				
108	Machine Oil	480 gal.	$ 288.00	$ .60	.60	City Oil Co.	11/20/28
"	Brooms	76 pc.	37.24	.49	.49	Williams Hdwe. Co.	12/6/28
"	Rough Lumber for Repairs	25,000 ft.	712.50	28.50	28.50	Andrews Lbr. Co.	11/26/28
109	Cotton Waste	250 lb.	25.00	.10	.10	Atkins Waste Co.	12/1/28
	Bolts, Nails, etc.		175.00	Estimated by Company—no change			
			1,237.74*				
	Office Supplies:						
109	Small Envelopes	85 bx (42,500)	84.15	1.98	1.98	Mass. Envelope Co.	3/21/28
"	Large "	5 " (2,500)	10.63	4.25	4.25	" " "	12/8/28
"	Small Letterheads	30 pkg. (30,000)	120.00	4.00	4.00	Daniels Printing Co.	12/3/28
"	Statements	10,000	98.30	9.83	9.83	" " "	11/21/28
			313.08*				
		Total Tested	$1,550.82				
		Total Inventory	$7,162.70				
		Per cent Tested	21%				

* Green.

Verification Included

Examination of original inventory sheets. Examination of original Invoices. Discussion with purchasing agent.

F. S.

Unexpired Insurance Premiums
Charles Darner Manufacturing Company, Boston, Massachusetts
December 31, 1928

K₄·

Policy No.	Company	Kind of Insurance	Location	Clause	Coverage	Date of Issue	Date of Expiration	Premium	Unexpired Time	Unexpired Amount
	Buildings and Contents									
30144	Firemen's Mutual Fire Ins. Co.	Fire	Main Plant	100 %	$ 200,000.00	8/1/28	8/1/29	$ 400.00		
91229	Mfg. Mutual Underwriters " "	"	" "	"	250,000.00	"	"	500.00		
31875	Merchants Mutual Fire " "	"	" "	"	100,000.00	"	"	200.00		
237337	Blackstone " " " "	"	" "	"	275,000.00	"	"	550.00		
259277	Arkwright " " " "	"	" "	"	75,000.00	"	"	150.00		
282619	Boston Mfg. " " " "	"	" "	"	300,000.00	"	"	600.00		
102847	Paper Mill " " " "	"	" "	"	400,000.00	"	"	800.00		
186542	Worcester Mfg. " " "	"	" "	"	200,000.00	"	"	400.00		
202584	Fall River "	"	" "	"	300,000.00	"	"	600.00		
		"	" "	"	2,100,000.00*			4,200.00*	7 mo.	$2,450.00
	Credit									
N 9382	National Surety Co.				50,000.00	6/1/28	6/1/29	1,095.92	5 mo.	456.65
	Paymaster Robbery									
1070293	Gen'l Acc. Fire & Life Asso. Corp.				15,000.00	6/1/28	6/1/29	269.36	5 mo.	112.25
	Autos and Trucks									
ALM5388	American Mutual	Public Liability Blanket Policy			500/1,000,000.00	1/1/28	1/1/29	540.00		
	" "	Property Damage " "			1,000.00	1/1/28	1/1/29	36.00		
								$ 576.00		
						Dividend 22 % per statement on file				126.72
162080	Autos Ins. Co. of New England Fire & Theft				6,000.00	8/1/28	8/1/29	112.00	7 mo.	65.31
Forward										$3,210.93

* Green.

UNEXPIRED INSURANCE PREMIUMS (*Continued*)

CHARLES DARNER MANUFACTURING COMPANY, BOSTON, MASSACHUSETTS
DECEMBER, 31, 1928

K_4 (*Continued*)

Policy No.	Company	Kind of Insurance	Location	Clause	Coverage	Date of Issue	Date of Expiration	Premium	Unexpired Time	Unexpired Amount
Brought	*Forward*									$3,210.93
	Workmen's Compensation									
50136 A	Am. Mutual Liab. Ins. Co. of Boston:									

	Rates per Policy			Actual Payroll K_{4a}	Premium Earned
Wool Spinning & Weaving	$150,000.00	$.731	$1,096.50	$227,679.20	$1,664.33
Clerical Office Employees	30,000.00	.050	15.00	38,502.40	19.40
Outside Salesmen	70,000.00	.101	70.70	84,350.58	85.19
Drivers & Drivers' Helpers	....	1.976	....	....	....
Chauffeurs & Helpers	6,500.00	1.471	95.62	7,117.68	104.70
			$1,277.82	$357,649.86	$1,873.62
Less: Dividend 22 %					412.20
Adjusted Earned Premium					$1,461.42
Advance Payment					1,277.82
Accrued Insurance				EE $	183.60†

Accrued Insurance (carried to Unexpired Amount)		183.60†
Per S. S. & Co.		$3,027.33
Per Company		3,773.62
	J.E. #24	$ 746.29

† Red.

Verification Included
Examination of individual policies. Examination of payroll records and ledger accounts. Computation.

B. A. W.

PAYROLL FOR COMPENSATION INSURANCE
CHARLES DARNER MANUFACTURING COMPANY,
BOSTON, MASSACHUSETTS
FOR THE TEN MONTHS ENDED DECEMBER 31, 1928 K_{4a}

		Wool Spinning and Weaving	Clerical Office Employees	Outside Salesmen	Chauffeurs and Helpers
March	1928	$ 23,866.40	$ 4,072.56	$ 8,072.40	$ 733.84
April	"	23,547.23	3,770.55	7,963.34	700.50
May	"	22,670.33	3,917.16	8,103.72	687.97
June	"	24,143.76	4,182.60	7,802.40	620.32
July	"	22,480.30	3,470.63	8,062.80	720.80
August	"	22,776.53	3,970.40	9,430.62	815.32
September	"	21,571.45	4,600.00	8,542.40	718.40
October	"	24,779.16	3,007.80	8,600.30	632.80
November	"	21,411.94	3,300.70	9,000.20	715.53
December	"	20,432.10	4,210.00	8,772.40	772.20
		$227,679.20	$38,502.40	$84,350.58	$7,117.68 K_4

F. S.

PREPAID TAXES
CHARLES DARNER MANUFACTURING COMPANY,
BOSTON, MASSACHUSETTS
DECEMBER 31, 1928 K_5

Paid To		Total Tax per Invoice	Prepaid	
			Portion	Amount
City of Boston (Paid 10/1/28)		$52,387.20	¼	$13,096.80
Assessed Values				
Real Estate	$1,091,400.00			
Personal Property	727,600.00			
Commonwealth of Massachusetts (Paid 9/30/28)				
Corporate Excise				
$461,611 at 5.00 per M		2,308.06	¼	577.02
Income				
$126,159 at 2½%		3,153.98		....
		5,462.04*		
Prepaid per S. S. & Co.				$13,673.82
Per Books				14,115.20
			J.E.#25	$ 441.38

* Green.

Tax invoices examined by B. A. Watt

B. A. W.

PREPAID WAGES
CHARLES DARNER MANUFACTURING COMPANY,
BOSTON, MASSACHUSETTS
DECEMBER 31, 1928 K_6

	Per Company	Adjustments	Per S. S. & Co.
Office Payroll:			
Week ending 1/2/29			
Paid 12/29/28 $630.00			
Prepaid 2 days or 4/11 of $630.00 =	$229.10		$229.10
Vacation Advance:			
Roy Wheeler—Stock Clerk for 2 Weeks ending 1/9/29 at $40.45	80.90		
Payroll Week Ends on Wednesdays Company didn't charge off for 3½ days ending 12/31/28			
7/11 of $40.45 =		$25.74	55.16
	$310.00	$25.74	$284.26
		J.E.#16	

See Accrued Wages EE_1 for Factory Payroll
Verification Included
Examination of payroll records
Computation

F. S.

Drafts against Letters of Credit
Charles Darner Manufacturing Company, Boston, Massachusetts
December 31, 1928

AA

Letter of Credit No.	Bankers	Due Date	Amount	Rate of Foreign Exchange	Dollars	Verification	Difference	How Verified, Etc.
B 9958	Kidder Peabody & Co., Boston, Mass.	1/6/29	$ 4,742.40		$ 4,742.40	$ 4,742.40	....	Direct Communication
753	Brown Brothers & Co. " "	3/12/29	13,347.80		13,347.80	13,347.80	....	" "
A 1006	The Third National Bank " "	2/6/29	£400	4.90	1,960.00	1,960.00	....	" "
563	Webster and Atlas National Bank, Boston, Mass.	1/17/29				4,342.20	4,342.20	" " (In Transit Mdse.)
					$20,050.20	$24,392.40	$4,342.20	
J.E. #17								
	Purchases	$4,342.20						
	Merchandise in Transit	4,342.20						
	Drafts against Letters of Credit		$4,342.20					
	Inventory P & L Dec. 31, 1928		4,342.20					

B. A. W.

Notes and Trade Acceptances Payable
Charles Darner Manufacturing Company, Boston, Massachusetts
December 31, 1928

BB

Date of Note	Payable To	Due Date	Amount		Int. Rate	Paid To	Interest: Time	Interest: Prepaid	Interest: Accrued	How Verified	Endorsers Other Remarks
	Notes—For Borrowed Money										
	Banks										
11/15/28	Third Nat.'l Bank, Boston, Mass.	1/5/29	$ 5,000.00		6 %	1/5/29	5 days	$ 4.17		Communication A1a2	End. by C. Darner
11/10/28	" " "	1/10/29	5,000.00		"	1/10/29	10 "	8.34		"	" " " "
11/20/28	" " "	1/20/29	5,000.00		"	1/20/29	20 "	16.68		"	" " " "
12/9/28	" " "	2/9/29	5,000.00		"	2/9/29	40 "	33.36		"	" " " "
12/20/28	" " "	2/10/29	5,000.00	$25,000.00	"	2/10/29	41 "	34.19		"	" " " "
10/20/28	Commonwealth National Bank, Boston, Mass.	1/20/29		25,000.00	6 %	1/20/29	20 "	83.33		"	" " " "
				50,000.00*							
	Brokers										
11/16/28	Donahue Bros., Boston, Mass.	1/15/29	5,000.00		6 %	1/15/29	15 "			"	" " " "
"	" " "	"	5,000.00		"	"	" "			"	" " " "
"	" " "	"	5,000.00		"	"	" "			"	" " " "
"	" " "	"	5,000.00		"	"	"			"	" " " "
"	" " "	"	5,000.00	25,000.00	"	"	"	62.50		"	" " " "
				25,000.00*							
	Officer										
4/30/28	C. Darner (Pres.), Boston, Mass.	Demand		15,000.00	6 %	none	245 "		612.50	"	
				15,000.00*							
Forward				$ 90,000.00							

* Green.

NOTES AND TRADE ACCEPTANCES PAYABLE (*Continued*)
CHARLES DARNER MANUFACTURING COMPANY, BOSTON, MASSACHUSETTS
DECEMBER 31, 1928

BB (*Continued*)

Date of Note	Payable To	Due Date	Amount		Int. Rate	Paid To	Interest: Time	Interest: Prepaid	Interest: Accrued	How Verified	Endorsers Other Remarks
Brought	Forward			$ 90,000							
	Notes—For Machinery Purposes										
11/17/28	Franklin Process Co., Boston, Mass.	5/17/29	$ 2,582.25		6 %	5/17/29	137 "	$ 58.95		Communication	Machinery purchased in prior years
"	" " " "	5/17/30†	2,582.25	$ 5,164.50	"	5/17/30	1 yr.–137	213.89		"	
				5,164.50*							
	Trade Acceptances—For Merchandise Purchases										
12/31/28	Atlas Yarn Co., New Bedford, Mass.	3/31/29		6,353.10	6%	3/31/29	90 days	95.30		"	
11/30/28	Abbot Yarn Co., Lawrence, Mass.	2/28/29		29,696.31	"	2/28/29	59 "	292.01		"	
12/30/28	New England Mfg. Co. Fall River, Mass.	3/31/29	$ 5,226.79		"	3/31/29	90 "	78.40		"	
12/15/28	" " " "	3/15/29	10,309.60		"	3/15/29	74 "	127.16		"	
12/27/28	" " " "	3/27/29	33,249.70	48,786.09	"	3/27/29	86 "	476.58		"	
				84,835.50*							
				$180,000.00				$1,584.86	$612.50		
				J.E. #27					EE J.E. #28		

NOTE: Note Payable Book also examined and checked.

A.T.

* Green.

† Show on Balance Sheet as Deferred Liability.

ACCOUNTS PAYABLE
CHARLES DARNER MANUFACTURING COMPANY,
BOSTON, MASSACHUSETTS
DECEMBER 31, 1928

CC

Payable to	Amount	
Otis Elevator Co.	$ 54.00	
Frank Bridges Co.	494.28	
Fales Trucking Co.	120.43	
N. Y. Lubricant Co.	437.30	
Boston Electric Light Co.	3,492.60	
N. E. Tel. and Tel. Co.	104.40	
N. Y. N. H. & H. R. R.	1,092.50	
Gibbs Process Co.	4,860.09	
Atlas Yarn Co.	3,597.80	
New England Mfg. Co.	33,780.26	
Abbot Yarn Co.	40,618.40	
Boston Machine Co.	2,018.60*	
Boston Stationery Co.	450.63	
Billings Elec. Co.	1,440.22	
Stratton Hdwe. Co.	2,076.56	
Hadley and Sons	1,340.62	
Doe, Jones and White, Attys.	1,235.00	
Dun's Credit Service	150.00	
Bakers Transportation Co.	192.40*	
Fitchburg Yarn Co.	37,949.40	
Specialty Yarn Co.	18,470.41*	25% advance on purchase contract for special yarns
Charles Darner, Pres.	6,480.50	Salary and Dividends
Frank Rice—Employee	1,480.00	Commissions
Ralph Drews	870.62	"
Balance per Books	$121,444.20	

J.E.#18

Accounts Payable per books	$121,444.20	
Trade Creditors' Debit Balances	2,211.00	
Advances on Raw Materials	18,470.41	
Accts. Pay.—Officers and Employees		$ 8,831.12
" " —Trade Creditors		133,294.49
	$142,125.61	$142,125.61

Summary

Accounts Payable per above	$133,294.49	
Unentered invoices CC_1	18,484.35	
Accounts Payable from Petty Cash count A_{3a2}	207.80	$151,986.64
Less: Contra accounts from Accts. Rec. D_1		1,416.90
Trade Creditors per Balance Sheet		$150,569.74

* Red.

Verification Included

Independent trial balance of accounts payable ledger.
Inspection of invoices.

F. S.

UNENTERED INVOICES

CHARLES DARNER MANUFACTURING COMPANY, BOSTON, MASSACHUSETTS
DECEMBER 31, 1928

CC1

Invoice Date	Receiving Date	Vendor	Description	Amount	Cr. Accounts Payable	Dr. Purchases	Dr. In Transit Cr. Inv. P & L 12/31/28	Dr. Expense	Remarks
12/27/28	12/31/28	Atlas Yarn Co.	10,860 lb.—#816 Blue	$6,353.10	$ 6,353.10	$ 6,353.10	....	....	Included in inventory but not in Accts. Pay.
12/31/28	1/3/29	New Bedford Yarn Mills	12,340 " —#922	6,787.00	6,787.00	6,787.00	$6,787.00	....	Not in inventory.
12/31/28	1/3/29	Abbot Yarn Company	1,000 " —#944	410.00	410.00	410.00	410.00	....	" " "
12/31/28	1/3/29	N. E. Mfg. Co.	3,500 " —#1430	1,750.00	1,750.00	1,750.00	1,750.00	....	" " "
12/31/28		Western Union	Telegrams for Dec. 1928	104.25	104.25	....	....	$ 104.25	Tel. & Tel.
12/28/28		Draper Corporation	Repair work—Looms	2,610.00	2,610.00	....	....	2,610.00	Repairs
12/29/28	12/30/28	Wards	Stationery, etc.	470.00	470.00	....	....	470.00	Office Supplies
12/31/28		Textile Assoc.	1929 Dues	500.00	(500.00)	....	....	....	Not adjusted
					$18,484.35	$15,300.10	$8,947.00	$3,184.25	
					CC		E		

Verification Included
Examination of cash disbursements subsequent to 12/31/28
Inspection of all invoices entered subsequent to 12/31/28, and all unentered.
Inspection of receiving records one week before and after 12/31/28

J.E.#19

Purchases	$15,300.10	
Raw Materials in Transit	8,947.00	
Repairs (Mfg.)	2,610.00	
Telephone and Telegraph	104.25	
Office Supplies	470.00	
Accounts Payable—Trade Creditors		$18,484.35
Inventory P & L 12/31/28		8,947.00
	$27,431.35	$27,431.35

A. T.

Unclaimed Wages
Charles Darner Manufacturing Company,
Boston, Massachusetts
December 31, 1928

DD

Balance January 1, 1928			$1,430.96
Additions			
Unclaimed Wages deposited:			
Jan.	$101.16		
Feb.	40.92		
Mar.	110.87		
Apr.	26.72		
May	187.90		
June	68.60		
July	78.15		
Aug.	108.66		
Sept.	89.77		
Oct.	90.83		
Nov.	116.70		
Dec.	177.02	$1,197.30	
Deductions			
12/31/28 Charging off liability for unclaimed wages over 1 yr. old		1,430.96	233.66
Balance 12/31/28			$1,197.30

Ran adding machine tape of individual items comprising the $1,197.30; also of all old balances charged off and not shown as a liability at 12/31/28.

F. S.

Accrued Accounts—Summary
Charles Darner Manufacturing Company,
Boston, Massachusetts
December 31, 1928

EE

Salaries and Wages	EE_1		$21,097.64
Interest:			
Bonds	FF	$13,041.65	
Notes and Trade Acceptances Payable	BB	612.50	13,654.15
Commissions	EE_2		8,350.00
Expenses:			
Water	EE_3	1,680.23	
Insurance	K_4	183.60	1,863.83
Taxes:			
Estimated Mass. Income Taxes	EE_4	5,959.61	
Estimated Federal " "	EE_4	27,890.99	33,850.60
			$78,816.22

B. A. W.

Accrued Salaries and Wages
Charles Darner Manufacturing Company, Boston, Massachusetts
December 31, 1928 EE1

Factory Payroll:

Payroll week ends on Saturday and payable following Wednesday

Payroll for week ended 12/29/28 pd. 1/2/29		$17,638.84
" " " " 1/5/29 " 1/9/29 =	$20,856.00	
Accrued 2/11 of $20,856.00		3,791.82
Estimated per S. S. & Co.		$21,430.66
Per Books		21,116.00
Difference (not adjusted)		$ 314.66

Officers' Salaries:

Examined salaries paid or credited to Officers' accounts for the entire year 1928. The individual amounts shown by operating schedules agreed with the salaries voted by directors per minutes.

Office Salaries: K_6

Summary:

Accrued Salaries and Wages per above	$21,116.00
Less: Prepaid items from Petty Cash Count ...... A_{3a2}	18.36
Accrued per Balance Sheet .... EE	$21,097.64

Verification Included

Examination of cash disbursements subsequent to 12/31/28.
" " payroll records.
" " minutes.

F. S.

Accrued Commissions
Charles Darner Manufacturing Company, Boston, Massachusetts
December 31, 1928 EE2

Six salesmen are paid bonus commissions in addition to regular commissions at the rate of 5% on all sales exceeding $100,000.00

	Actual Sales	Excess	Commission
Frank Rice	$147,000.00	$47,000.00	$2,350.00
Ed. Rand	122,000.00	22,000.00	1,100.00
Ralph Drews	135,000.00	35,000.00	1,750.00
Wm. Danford	142,000.00	42,000.00	2,100.00
J. Martin	121,000.00	21,000.00	1,050.00
Balance per Books and S. S. & Co.		EE	$8,350.00
L. G. Sampson G_2	144,755.00	44,755.00	$2,237.55
(This amount deducted from Advances to Salesmen under Other Assets)			

Verification Included

Examination of sales analysis record
Computation

F. S.

Accrued Water
Charles Darner Manufacturing Company,
Boston, Massachusetts
December 31, 1928

EE3

City of Boston		
Water Service		
Period 2/10/28 to 8/10/28 =	$2,160.30	
Average cost per mo.	360.05	
Period 8/10/28 to 12/31/28		
Estimated 4⅔ mo. at	360.05 =	$1,680.23
		J.E.#29—EE

Invoice examined by F. Seney

F. S.

Federal and State Income Taxes—Estimated
Charles Darner Manufacturing Company,
Boston, Massachusetts
For the year ended December 31, 1928

EE4

Net Profit before Taxes per S. S. & Co.				$209,837.35
Additions				
Organization Expense Amortized	K2	$20,750.00		
Officers' Life Insurance Premiums	F	5,426.00		
Adjusting Securities to Market	B	4,686.50	$30,862.50	
Deductions				
Increase in Cash Value—Life Insurance	F	$ 1,939.33		
Dividends on Life Insurance Premiums	F	376.00	2,315.33	28,547.17
Net Income Subject to State Tax				$238,384.52
Less: Estimated State Income Tax at 2½%				5,959.61
Net Income Subject to Federal Tax				$232,424.91
Estimated Federal Income Tax at 12%				$ 27,890.99
Summary				
Estimated Mass. Income Taxes			$ 5,959.61	} J.E.#34
" Federal " "			27,890.99	}
		EE	$33,850.60	

F. S.

BONDED INDEBTEDNESS
CHARLES DARNER MANUFACTURING COMPANY, BOSTON, MASSACHUSETTS
DECEMBER 31, 1928

FF

Outstanding Bonds

First Mortgage 5 % 10 yr. Gold Bonds due Aug. 1, 1937			
Outstanding			$630,000.00
Balance Jan. 1, 1928 (Original Issue)		$700,000.00	
Less: Retired Aug. 1, 1928 (as per indenture)		70,000.00	$630,000.00
Interest:			
Payable Feb. 1 and Aug. 1, last payment Aug. 1, 1928			
5 mos. accrual (5 %) on outstanding $630,000 =			$ 13,125.00
Less: accrual on Treasury Bonds $4,000			83.35
Accrued Interest per S. S. & Co.	EE		$ 13,041.65
Per Company			11,875.00
	J.E.#30		$ 1,166.65

Treasury Bonds

Number of Bonds	Certificate Nos.	Par Value	How Verified
1	90	1,000.00	Examination
3	120, 121, 122	3,000.00	"
		4,000.00	

Jan. 29, 1929
Received of Representative of Seymour, Sibley & Co. four bonds of a total par value of $4,000.00 as listed above

PETER CRANSTON

Recapitulation:

First Mortgage 5 % Gold Bonds due Aug. 1, 1937	$630,000.00
Less: In Treasury	4,000.00
	$626,000.00

Bonds Outstanding Verified by Correspondence with Trustee

Indenture:

Bay State Trust Co., Trustees
Interest payable—Feb. 1 and Aug. 1
Property mortgaged—entire real estate
On July 31st of each year there is to be deposited with the Trustee cash or bonds sufficient to retire 1/10 of the original issue at $102.00

B. A. W.

VERIFICATION OF BONDED INDEBTEDNESS

Bay State Trust Company,
Boston, Mass.

Gentlemen: FF_1

Will you kindly furnish our auditors, Seymour, Sibley and Co. 50 Federal Street., Boston, Mass., with the following information as of December 31, 1928, relative to the Bonded Indebtedness of this Company of which you act as Trustee:

Description of Bonds
Amount outstanding
Date Interest paid to
Insurance held

We enclose a stamped envelope for your convenience.

Very truly yours,

CHARLES DARNER MFG. CO.
By PETER CRANSTON

Capital Stock
Charles Darner Manufacturing Company, Boston, Massachusetts
December 31, 1928

GG

Common

Total authorized 15,000 shares—par $100			$1,500,000.00
Less: Unissued		$450,000.00	
In Treasury		50,000.00	500,000.00
			$1,000,000.00

Issued Cert. No.	*Issued To*	*Shares Outstanding*
1	Darner, Charles	3,000
2	Cranston, Peter	1,500
4	Jones, Robert	500
9	Rice, Edward G.	100
11	Jones, Robert	250
12	" "	250
15	Babcock, Geo	125
17	Ross, John	275
20	Lindberg, E. E	600
21	Watt, B. A.	400
22	Black, C. A.	1,000
24	Jones, Robert	250
26	Seldon, A. A.	650
28	Sallet, Louis	250
30	Shannon, J. J	350
32	Brown, A. B	1,000
		10,500*
In Treasury		
9	Rice, Edward G.	100 Endorsed
15	Babcock, Geo	125 in
17	Ross, John	275 blank
		500*
	Total Outstanding	10,000

Preferred

7 % Cumulative
Authorized and issued 5,000 shares—par $100 .... $500,000.00

Verified by direct communication with the Bay State Trust Company, Transfer Agent.

* Green.
Issued stock verified by examination of stock certificate books, Treasury stock by examination of actual certificates.

A. Teppert

Jan. 29, 1929
Received of Representative of Seymour, Sibley & Co. 500 shares of Charles Darner Mfg. Co. common stock.

Peter Cranston.
A. T.

VERIFICATION OF PREFERRED STOCK

Bay State Trust Co.,
Boston, Mass.

Gentlemen: GG$_1$

Will you kindly furnish our auditors, Seymour, Sibley & Co., 50 Federal St., Boston, Mass. with the following information as of December 31, 1928, relative to the Preferred Stock of this Company, of which you act as Transfer Agent:

Number of shares authorized
" " " issued
Par value

A self-addressed stamped envelope is enclosed for your reply.

Very truly yours,

CHARLES DARNER MFG. CO.
By PETER CRANSTON

Reconciliation of Surplus
Charles Darner Manufacturing Company, Boston, Massachusetts
December 31, 1928

HH

Surplus per Company	HH_1				$1,211,210.65
		Additions			
Adjusting the following Assets and Expenses:					
Depreciation written off	H_2	$ 2,858.25			
Patent amortization	I	1,185.30			
Cash Value—Life Insurance	F	864.63			
Cash for interest, bank charges, etc.	A_1	469.20	$ 5,377.38		
Providing for the following Prepaid and Accrued Interest:					
Notes Payable—Prepaid Interest	BB	$ 1,584.86			
Marketable Securities—Acc. "	B	716.10			
Certificates of Deposit " "	A_2	375.00			
Mortgages Receivable " "	G_3	12.25	2,688.21	$ 8,065.59	
		Deductions			
Providing for the following Accrued Expenses and Liabilities:					
Federal and State Income Taxes	EE_4	$33,850.60			
Common Dividend	Y	20,000.00			
Unentered Purchase Invoices	CC_1	6,353.10			
" Expense "	CC_1	3,184.25			
Commissions	G_2	2,237.55			
Water	EE_3	1,680.23			
Interest—Notes Payable	BB	612.50			
Expenses	A_{3a2}	183.16			
Traveling	A_{3a2}	142.82			
Interest—Life Insurance Loan	F	105.86	$68,350.07		
Providing for the following:					
Amortization of Bond Discount	K_1	$17,586.10			
Allowance for Doubtful Notes	C	1,390.10			
Additional Allowance for Doubtful Accounts	D_3	1,000.00			
Depreciation on Outside Real Estate	G_1	457.45			
Loss on Sale of Capital Assets	H_1	403.60	20,837.25		
Adjusting the following items:					
Consigned Goods to cost	D_1	$ 6,350.00			
Inventories for errors in prices and computations	E_1	5,351.76			
Securities to Market	B	4,686.50			
Accrued Interest on Bonds	FF	1,166.65			
Prepaid and Accrued Insurance	K_4	746.29			
Prepaid Taxes	K_5	441.38			
Expense charged to patents	I	300.00			
Accrued Interest—Notes Receivable	C	25.75			
Prepaid Wages	K_6	25.74	19,094.07	108,281.39	100,215.80
Surplus per Balance Sheet					$1,110,994.85

A. T.

ANALYSIS OF SURPLUS PER BOOKS
CHARLES DARNER MANUFACTURING COMPANY,
BOSTON, MASSACHUSETTS
FOR THE YEAR ENDED DECEMBER 31, 1928 HH1

Balance, January 1, 1928					$1,072,499.70
Addition					
Net Profit for the year				$256,202.55	
Deductions					
Dividends Paid					
Preferred					
2/1/28 1 ¾%	$ 8,750.00				
5/1/28 " "	8,750.00				
8/1/28 " "	8,750.00				
11/1/28 " "	8,750.00	$ 35,000.00			
Common					
1/15/28 2%	$20,000.00				
4/15/28 "	20,000.00				
7/15/28 "	20,000.00				
10/15/28 "	20,000.00	80,000.00			
		115,000.00*			
Additional assessment—1926 Federal Income Taxes		2,491.60	117,491.60		138,710.95
Balance per Books December 31, 1928 J.E.#32.					$1,211,210.65HH

* Green.

A. T.

CLIENTS' CERTIFICATE

Seymour, Sibley & Co.
50 Federal St.,
Boston, Mass.

Gentlemen: X

The following certifications and/or representations are made for the purpose of enabling you to prepare a proper statement of the financial condition of the Charles Darner Mfg. Co., at the close of business December 31, 1928.

The Company had clear title to all of the assets carried on its books at December 31, 1928, none of which were then pledged or assigned in any manner, and all of its then tangible assets had been recorded on its regular and ordinary books of account at or before December 31, 1928.

An actual inventory was made as at December 31, 1928, of materials, supplies and merchandise then on hand. The undersigned is familiar with the method of inventory taking which was employed at said date; is also familiar with the quality, the salability and/or usability of the inventories at the date above named, and is fully satisfied and does hereby certify that, in his opinion, the aggregate amount of $1,196,233.55 is a true and correct valuation representing only actual quantities on hand or in transit and fairly reflecting the condition of the inventories as to salability and usability; that the prices used represent cost or market whichever is lower, and are not in excess of realizable

X (*Continued*)

value; that no materials, supplies or merchandise held by the Company on consignment were included in the said valuation. The undersigned states that Seymour, Sibley & Co. are fully justified in stating said amount in their Statement of Condition of this Company as being a good asset to the best of his knowledge or belief.

Accounts Receivable aggregating $296,687.78 and Notes Receivable aggregating $15,638.15 are to the best of my knowledge and belief valid debts due to this Company. Customers' Accounts Receivable amounting to $269,474.23 and Customers' Notes Receivable amounting to $14,113.15 all represent bona fide sales. None of the accounts include any amounts for merely consigned merchandise. The allowances totaling $17,390.10 for possible loss on doubtful notes and/or accounts, for discounts, etc., are, to the best of my knowledge and belief, sufficient to cover any shrinkage in the book value of the notes and/or accounts anticipated at the above named date.

Every effort was made to record on the regular books of account at or before December 31, 1928, liabilities of the Company for materials received or expenses incurred prior to the close of business on that date, and, to the best of my knowledge and belief provision has been made on the books of account for all liabilities of this Company at that date, with the exception of invoices aggregating $26,610.60 covering merchandise in transit, no part of which has been included in the inventory or charged to our trade at that date.

The Company was not, at the date named, contingently liable as endorser or guarantor on (1) any accommodation paper, or (2) contract or agreement whatsoever; had no outstanding contracts of a speculative nature for material or other items; had no damage or law suits or judgments pending against it and was not otherwise contingently liable on discounted notes, trade acceptances or other form of obligation.

There have been no special matters occurring during the period covered by this audit in so far as the undersigned has knowledge, which would have any bearing on your report and there have been no shortages or irregularities which have already been closed or which are now in abeyance. There are no suspicions or matters of a personal nature reflecting on the honesty of members of our organization in so far as we have any information.

It is understood that this examination was not to include and did not include a detailed audit of the recorded cash or other transactions during the period covered by your examination such as would be required for the purpose of discovering any possible irregularities therein.

CHARLES DARNER—*President*
PETER CRANSTON—*Treasurer*

Place Boston
Date

MINUTES
CHARLES DARNER MANUFACTURING COMPANY,
BOSTON, MASSACHUSETTS
FOR THE YEAR ENDED DECEMBER 31, 1928 Y

Directors 1/10/28
Common dividend 2% payable 1/15/28 as of 1/10/28
Preferred " 1¾% " 2/1/28 " " 1/25/28
Stockholders—Annual 2/23/28
Clerk A. R. Conway
President Charles Darner
Directors Charles Darner
Peter Cranston
R. M. Darner
Quentin George
E. V. Cecil
S. S. & Co. as auditors for year 1928
Acts of Directors for year 1927 ratified and approved.
Directors—Annual 2/23/28
Treasurer Peter Cranston
Vice-President R. M. Darner
Asst. Treasurer E. V. Cecil
Salaries for 1928

President	$30,000.00
Vice-President	20,000.00
Treasurer	25,000.00
Asst. Treasurer	15,000.00
	$90,000.00

Directors—4/10/28
Common dividends 2% payable 4/15/28 as of 4/10/28
Preferred " 1¾% " 5/1/28 " " 4/25/28
Directors—7/10/28
Common dividend 2% payable 7/15/28 as of 7/10/28
Preferred " 1¾% " 8/1/28 " " 7/25/28
Directors—10/10/28
Common dividend 2% payable 10/15/28 as of 10/10/28
Preferred " 1¾% " 11/1/28 " " 10/25/28
Directors—12/20/28 *Special*
Common dividend (extra) 2% payable 1/15/29 as of 12/25/28
Minutes read in detail by B. A. Watt

QUESTIONNAIRE Z

This form is to serve as a reminder to investigate certain features often omitted and is not intended as a complete working program. It is to be included in the papers on every job and is to be signed by the accountant in charge, as well as the supervisor, who shall see that all points have been covered and relative comments and papers included in the appropriate folder where necessary. Where possible answer "Yes" or "No."

NAME OF CLIENT CHARLES DARNER MFG. CO. ORDER NO. 4612
DATE December 31, 1928

SCOPE OF WORK (Cash, Detailed, Semi-Detailed or Balance Sheet Audit, Investigation or Examination.) Balance Sheet Audit

CASH Outline briefly the extent of examination of Cash Records and Vouchers.

Examined and checked cancelled checks for months of March, June, October and December 1928 and traced recorded cash receipts for same periods. Proved cash book footings. Same procedure from December 31, 1928 to Jan. 15, 1929.

Are all bank verifications returned and checked and did you correspond with every bank you found the Company had done business with recently? Yes

In case of a Balance Sheet Audit have you traced at least the last month's receipts into bank deposits, examined that month's cancelled checks and independently reconciled the bank accounts? Yes

If the cash was not counted on the date of the audit, did you, at the beginning of the work, count both the Petty Cash and Undeposited Receipts and reconcile the bank accounts as of that date, as well as reconcile the Petty Cash count with the Fund as of the date of the audit? Yes

Did you make a second count of Cash? Yes

Did the Cash Transactions near the close of the period (before or after) show any large items of an unusual nature such as payment of officers' accounts, temporary reduction of Notes Payable or other receipts or disbursements out of the ordinary. No

From what you observed as to the Company's business, system, etc., (Internal Check) are you satisfied with the tests you have made in respect of Cash transactions? Yes

SECURITIES

Have you examined or otherwise accounted for all Securities disclosed by the Company's records and satisfied yourself that such Securities were the property of the Company and in its name? Yes

What is the basis of valuation? Lower of cost or market

Z (*Continued*)

NOTES AND ACCEPTANCES RECEIVABLE

Have all Notes and Acceptances been examined or otherwise accounted for and has investigation been made as to source, personal notes, renewals, etc., and non-current items included under proper classification? Yes

Are any Notes or Acceptances discounted, assigned or pledged as collateral? No

ACCOUNTS RECEIVABLE

Was an independent trial balance taken showing age, subsequent payments, post datings and installment accounts? Yes

Did you discuss the advisability of corresponding with the Customers or placing our rubber stamp on the Company's Statements? Yes

If you did not correspond did you secure properly signed request from the management? We sent out 200 verifications.

Do the Accounts include balances other than those of regular customers, such as personal, branches, subsidiary or affiliated concerns, claims, stock subscriptions, consignments, etc.? Yes

If so, did you get details and segregate and classify such accounts properly and in respect of consignments did you reduce to inventory basis? Yes

Are there any large balances represented in the Accounts? No

If so, did you make careful investigation as to possible affiliations and as to advisability of bringing out the condition in our report? Yes

Are any of the accounts discounted, sold, assigned or pledged as collateral? No

Did you examine the shipping records for a period both prior and subsequent to the date of the Audit for the purpose of making sure that goods represented in invoices rendered around the close of the period and included in the sales for the period, had actually been shipped, or ascertaining whether any goods had been shipped but not charged? Yes

INVENTORY

Was inventory a "Physical" or "Book" Inventory? Physical

Have you segregated the inventory as to finished, in process, raw materials, supplies, branch inventories, consigned and other items, if any, and do your working papers indicate the extent of verification? Yes

Have you secured full information as to obsolete stock? Yes

Is any part of inventory hypothecated or subject to lien? Yes—Drafts

What verification did you make as to

Quantities? Tests of Raw Materials and Finished Goods

Mathematical Accuracy? All items over $50.

Z (*Continued*)

Prices? See work sheets

Salability? Tests

Does the concern operate a cost system? Yes

If so, is it co-ordinated with the general books? Yes

Did you compare prices used with the cost records? Yes

Also with Net Selling Prices? Yes

What percentage was added to cover overhead? See work sheets

Is the rate accurate? Yes

Have you included a schedule of overhead rates? Yes

How does it compare with previous years? Same

Did you compare prices of materials with recent invoices? Yes

Did you satisfy yourself that all liabilities for merchandise included in the inventory had been provided for and that proper consideration had been given to shipments around the period of inventory taking? Yes

Did you compare inventory with previous years and obtain satisfactory explanation of any large changes? Yes

Had the concern, prior to the date of this Audit, entered into any contracts for the purchase of materials undelivered at that date? Yes—See Schedule

Had the concern any uncompleted sale contracts in force at the date of this Audit? Yes—See Schedule

Have you secured signed certificates from proper officials? Yes

OFFICERS' AND MISCELLANEOUS ACCOUNTS

Do you have a complete analysis of officers' accounts in your working papers and have you carefully investigated large balances and secured signed verifications? Yes

Are you satisfied that all credits due for salaries, bonuses, commissions, etc., have been entered? Yes

PERMANENT What is the basis of valuation? Cost less depreciation

Does the Company follow a conservative policy with respect to additions, depreciation and obsolescence? Yes

If any items have been discarded or sold, have the proper entries been made? Yes

Have any items been fully depreciated? Yes

LIABILITIES

Have you secured statement of monthly balances of Notes and Acceptances and Accounts Payable? Yes

Have you investigated the origination of all Notes and Accounts Payable and independently verified the notes? Yes

Have you reviewed transactions subsequent to the date of audit for liabilities not provided for and satisfied yourself that all liabilities are provided for? Yes

Z (*Continued*)

TAXES Have you obtained full information with reference to taxes of all kinds? Yes

Have you obtained a copy of the Personal Property Tax Return, if not prepared by us? Yes

RESERVES Have you obtained complete detail of all Reserves and are you satisfied as to the adequacy of each Reserve and that all necessary Reserves are provided? Yes

SUNDRY Have you investigated the concern's contractual situation? Yes

Are there any contingent liabilities? No

Are there any large changes in Income & Expense items during the current period as compared to the previous period? No

If so, have you secured satisfactory explanation? ____________

Were control accounts all in balance with detail?, Yes

Have you read the minutes covering Directors' and Stockholders' meetings and checked Dividend declarations with payments, Officers' Salaries and Bonus Authorizations and any other items passed upon by the Directors? Yes

Are you satisfied that the cost and general accounting procedure adequately meet the client's needs? Yes

Have these matters, or any other special services, been discussed with the management? Yes

If so, with whom? Charles Darner, President
Peter Cranston, Treasurer

Is a budget in use? No

If so, how did results compare with forecast made? ____________

Have you filled out the Statistics Department Questionnaire? Yes

Has the scope of your examination been sufficient in your opinion to fully warrant Seymour, Sibley & Co. to issue the report as prepared by you? Yes (If not, state your reasons below.)

The matters referred to in the foregoing questions have been carefully investigated and the relative answers given are true, to the best of my knowledge and belief.

Signed A. TEPPERT
Accountant

Date Mar. 20, 1929

B. A. WATT
Supervisor

REMARKS

(State briefly any transactions made after the date of this Balance Sheet, which would materially affect the financial position of the concern. Mention any items which you think should be given special consideration before the report is released.)

Charles Darner Manufacturing Company
Auditors' Report
Year Ended December 31, 1928

SEYMOUR, SIBLEY & COMPANY
ACCOUNTANTS AND AUDITORS
50 FEDERAL STREET
BOSTON, MASSACHUSETTS

Report of Examination
Charles Darner Manufacturing Company,
Boston, Massachusetts
December 31, 1928

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Page 1

Charles Darner Mfg. Co.,
Boston, Mass.

Gentlemen:

We have completed our examination of the books of account and record pertaining to the assets, liabilities and capital of Charles Darner Mfg. Co. Boston, Massachusetts, as at December 31, 1928, and submit herewith our report.

Scope of Examination

Our examination included a verification of the assets, liabilities and capital of the Company at December 31, 1928, a general review of the operating results for the year then ended, and an investigation of the recorded cash and other transactions as outlined later in this report.

Financial Condition

A Balance Sheet is attached hereto showing the financial condition of your Company at December 31, 1928, which we have condensed and compared with a similar statement at December 31, 1927, as follows:

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	Dec. 31, 1928	Dec. 31, 1927	Increase Decrease*
Current Assets	$1,748,364.71	$1,717,009.65	$31,355.06
Current Liabilities	461,626.07	478,610.40	16,984.39*
Working Capital	$1,286,738.70	$1,238,399.25	$48,339.45
Other Assets	69,508.60	69,236.48	272.12
Permanent Assets	1,656,208.85	1,736,644.19	80,435.34*
Patents	15,894.80	12,950.68	2,944.12
Goodwill	100,000.00	100,000.00	....
Deferred Charges	111,362.65	115,269.10	3,906.45*
	$3,239,713.60	$3,272,499.70	$32,786.10*
Deferred Liability	$ 2,582.25	....	$ 2,582.25
Deferred Income	136.50	....	136.50
Bonded Indebtedness	626,000.00	$ 700,000.00	74,000.00*
Capital Stock	1,500,000.00	1,500,000.00	....
Surplus	1,110,994.85	1,072,499.70	38,495.15
	$3,239,713.60	$3,272,499.70	$32,786.10*

* Red.

Page 2 (*Continued*)

From this comparison it will be noted that an increase in Current Assets and a decrease in Current Liabilities in the respective amounts of $31,355.06 and $16,984.19 resulted in an increase of $48,339.45 in Working Capital, which may be explained as follows:

Working Capital January 1, 1928				$1,238,399.25
Additions				
Net Profit per Income and Expense		$175,986.75		
Add: Items not requiring withdrawal of Working Capital				
Depreciation	$104,465.60			
Amortization—Patents	2,755.88	107,221.48		
		$283,208.23		
Decrease in Deferred Charges		3,906.45		
Increase in Deferred Liabilities and Deferred Income		2,718.75	$289,833.43	
Deductions				
Dividends paid		$135,000.00		
Mortgage Bonds retired	$ 70,000.00			
Treasury Bonds purchased	4,000.00	74,000.00		
Invested in Plant and Equipment	$ 24,030.26			
Invested in Patents	5,700.00	29,730.26		
Additional assessment—Federal Taxes		2,491.60		
Increase in Miscellaneous Notes and Accounts Receivable		272.12	241,493.98	48,339.45
Working Capital December 31, 1928				$1,286,738.70

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The individual Current Assets and Liabilities and their relative percentage of the total Current Assets compared as follows at December 31, 1928 and 1927.

	Dec. 31, 1928		Dec. 31, 1927		Increase Decrease*	
	Amount	% to Total Current Assets	Amount	% to Total Current Assets	Amount	% to Total Current Assets
Current Assets						
Cash	$ 201,929.26	11.55	$ 117,775.70	6.86	$84,153.56	4.69
Marketable Securities	77,528.60	4.43	81,500.00	4.74	3,971.40*	.31*
Notes and Trade Acceptances Receivable	10,929.30	.63	9,610.73	.56	1,318.57	.07
Accounts Receivable	255,685.23	14.62	277,237.48	16.15	21,552.25*	1.53*
Merchandise Inventories	1,196,233.55	68.42	1,225,691.60	71.38	29,458.05*	2.96*
Cash Value—Life Insurance	6,058.77	.35	5,194.14	.31	864.63	.04
	$1,748,364.71	100.00	$1,717,009.65	100.00	$31,355.06	....
Current Liabilities						
Notes Payable	$ 92,582.25	5.30	$ 125,000.00	7.28	$32,417.75*	1.98*
Drafts against Letters of Credit	24,392.40	1.40	28,610.25	1.67	4,217.85*	.27*
Trade Acceptances Payable	84,835.50	4.85	75,000.00	4.37	9,835.50	.48
Accounts Payable	160,999.64	9.21	179,562.23	10.45	18,562.59*	1.24*
Dividends Payable	20,000.00	1.14	20,000.00	1.16	....	.02*
Accrued Accounts	44,965.62	2.57	39,826.72	2.32	5,138.90	.25
Income Taxes	33,850.60	1.94	10,611.20	.62	23,239.40	1.32
	$ 461,626.01	26.41	$ 478,610.40	27.87	$16,984.39*	1.46*
Working Capital	$1,286,738.70		$1,238,399.25		$48,339.45	
Current Ratio	3.79 to 1		3.59 to 1		.20 to 1	

* Red.

It will be noted that there was an improvement in the cash position of the Company during the year under review. There was also some reduction in inventories but these still constituted a very substantial percentage of the total current assets and approximately 63% of the inventories represented finished goods, as may be noted in the comparison shown elsewhere in this report.

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Operations

Operations for the year ended December 31, 1928, as shown in the annexed statement of Income and Expense, resulted in a net profit of $175,986.75, and may be compared with the results of the previous year as follows:

	For the Year Ended December 31,				Increase Decrease*	
	1928		1927			
	Amount	% Net Sales	Amount	% Net Sales	Amount	% Net Sales
Net Sales	$2,460,472.30	100.00	$2,261,394.71	100.00	$199,077.59	.....
Cost of Goods Sold	1,860,546.09	75.62	1,776,362.03	78.55	84,184.06	2.93*
Gross Profit	$ 599,926.21	24.38	$ 485,032.68	21.45	$114,893.53	2.93
General, Administrative and Selling Expenses	300,940.43	12.24	302,410.60	13.37	1,470.17*	1.13*
Net Operating Profit	$ 298.985.78	12.14	$ 182,622.08	8.08	$116,363.70	4.06
Other Income	10,512.32	.44	9,987.25	.44	525.07	.....
Other Deductions	99,660.75	4.05	102,310.66	4.53	2,649.91*	.48*
	89,148.43*	3.61*	92,323.41*	4.09*	3,174.98*	.48*
Net Profit Before Taxes	$ 209,837.35	8.53	$ 90,298.67	3.99	$119.538.68	4.54
Income Taxes	33,850.60	1.38	10,611.20	.47	23,239.40	.91
Net Profit to Surplus	$ 175,986 75	7.15	$ 79.687.47	3.52	$ 96,299.28	3.63

* Red.

The improved results for the current year were made possible by the increase in the volume of sales together with savings in manufacturing and operating expenses. Sufficient economies were effected in selling and administrative expenses that the dollar total of these expenses actually decreased in the face of increased sales of $199,077.59.

Balance Sheet Comments

Your attention is invited to the following comments relative to the items appearing on the attached Balance Sheet:

Cash—$201,929.26. The distribution of the cash resources of the Company at December 31, 1928, aggregating $201,929.26, is detailed in a separate exhibit. We confirmed the cash on deposit and in transit by direct communication with the various depositories and counted the cash on hand. Our test of the recorded transactions is outlined later in this report.

Marketable Securities—$77,528.60. Securities in this aggregate, as shown in a separate exhibit, were carried at the lower of cost or market values and were verified by inspection of the individual certificates and by computation of accrued interest.

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Notes and Trade Acceptances Receivable—$10,929.30. The notes and acceptances detailed in an exhibit attached hereto, were verified by

Page 5 (*Continued*)

inspection. We have provided an allowance of $1,390.10 to cover possible loss in collection of past due and doubtful notes.
Accounts Receivable—$255,685.23. We have included under this caption the following:

Customers—Domestic	$244,083.98	
Foreign Drafts Drawn	25,390.25	$269,474.23
Less: Allowance for Doubtful and Discounts		16,000.00
		$253,474.23
Trade Creditors Debit Balances		2,211.00
		$255,685.23

As requested, we did not communicate directly with customers in verification of the open balances, but we prepared an independent trial balance of the accounts and analyzed the age of the unpaid balances with the following result:

Realized to January 31, 1929—Cash	$ 92,834.70
—Discount	2,338.95
Charges—December, 1928	79,081.05
" —November, 1928	32,789.57
" —October, 1928	10,750.94
" —July to September, 1928	5,412.45
" —January to June, 1928	12,069.97
" —Prior to 1928	8,806.35
	$244,083.98

We reviewed the accounts with the Treasurer of the Company and believe that the allowance of $16,000.00 provided for doubtful accounts and discounts should prove adequate. We have shown the larger balances due from customers in a separate exhibit.
Merchandise Inventories—$1,196,233.55. An exhibit is appended comparing in detail the inventories at the end of the past two years. We made tests of the physical counts of stock as taken by employees of the Company. We also tested the accuracy of extensions, footings and summaries of inventory sheets, and investigated the method of pricing used. Our examination indicated that inventories were valued at prices not in excess of the lower of cost or market.
Cash Surrender Value—Life Insurance—$6,058.77. We examined insurance policies of a total face value of $155,000.00, covering the lives of officers of the Company as shown in a separate exhibit. We verified the cash value by computation and by direct confirmation.
Other Assets—$69,508.60. The items included under this caption are set forth in a separate exhibit and were verified by inspection of notes and certificates and by examination and analysis of ledger accounts and other supporting data.
Permanent Assets—$1,656,208.85. Land, Buildings, Machinery, Equipment etc. are stated at depreciated book values without appraisal by

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us and a summary of the changes during the year under review is included in an annexed exhibit. Additions during the current year were supported by original invoices examined by us and appeared to represent proper capital charges. The total depreciation charged to current operations aggregated $104,465.60.

Patents—$15,894.80. This represented the unamortized book value of Patents at December 31, 1928. During the year there was an addition of $5,700.00 for expenses in connection with a new patent and amortization of $2,755.88 was charged to operations.

Goodwill—$100,000.00. There was no change in Goodwill during the year under review.

Deferred Charges—$111,362.65. Sundry charges to future operations as detailed in a separate exhibit were proven by examination of inventory sheets and correspondence on file or by computation.

Notes Payable—$92,582.25.

Drafts Against Letters of Credit—$24,392.40.

Trade Acceptances Payable—$84,835.50.

The notes, drafts and trade acceptances listed on separate exhibits attached hereto, were verified by direct correspondence. It will be noted that one note for machinery purchased in the amount of $2,582.25 was not payable until May 17, 1930, and has been shown as a Deferred Liability on the Balance Sheet.

Accounts Payable—$160,999.64. The liabilities of the Company on open account, etc. as grouped under this caption were verified by subsidiary trial balances, inspection of creditors' statements and by examination of invoices entered and payments made subsequent to the audit date.

Dividend Payable—$20,000.00. Provision has been hereby made for the extra dividend of 2% on the common stock declared December 20, 1928, payable January 15, 1929.

Accrued Accounts—$44,965.62. Accrued wages, interest, commissions, etc. in this total were computed by us.

Federal and State Income Taxes (Estimated)—$33,850.60. We have estimated the liability of the Company for taxes on current income as follows:

Federal................	$27,890.99
State of Massachusetts..	5,959.61
	$33,850.60

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Bonded Indebtedness—$626,000.00. We received a certificate from the Bay State Trust Company, Trustees, that the total first Mortgage 5% Gold Bonds due August 1, 1937, outstanding at December 31, 1928, amounted to $630,000.00. Treasury Bonds of a total par value of $4,000.00 were examined by us. In accordance with the terms of the

Page 7 (*Continued*)

indenture, bonds of a total par value of $70,000.00 were retired on August 1, 1928.

Capital—$2,610,994.85. This comprised the following:

Capital Stock		
Preferred	$ 500,000.00	
Common	1,000,000.00	$1,500,000.00
Surplus		1,110,994.85
		$2,610,994.85

We verified the outstanding Preferred Stock by direct correspondence with the Bay State Trust Company, Transfer Agents, and the Common Stock by an independent trial balance of the stock certificate books. Certificates held in the Treasury were examined by us.

The increase of $38,495.15 in Surplus during the year is explained in a separate exhibit.

Contingent Liabilities.

No contingent liabilities were disclosed by our examination and we were informed that none existed.

Federal Taxes.

The Federal Tax returns of the Company have been audited and settled thru the year 1925, and our Balance Sheet is subject to any adjustment in returns of subsequent years.

Insurance.

A summary of the insurance policies examined by us, evidencing the Company's protection against loss by fire, theft or other casualties, is included elsewhere in this report.

Examination of Recorded Transactions.

We made a detailed examination of the recorded cash transactions of the Company for the months of March, June, October and December 1928. For these months recorded cash receipts were traced to depositories' statements, cancelled checks examined and compared with cash book entries, original invoices and other data inspected in support of disbursements, and footings of cash records proven. No exceptions were noted.

In addition we tested the payroll records for the weeks ended April 4 and September 6, 1928, supervising the actual pay-off for the latter week.

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General.

Our representatives were extended every courtesy and assistance by the employees and officers of the Company.

Very truly yours,

SEYMOUR, SIBLEY & CO.

BALANCE
CHARLES DARNER MANUFACTURING
DECEMBER
Page

ASSETS				
Current:				
Cash:				
On Deposit		$ 190,996.00		
In Transit		10,225.60		
On Hand		707.66	$ 201,929.26	
Marketable Securities (and Accrued Interest)			77,528.60	
Notes and Trade Acceptances Receivable:				
Customers	$ 12,277.40			
Accrued Interest	42.00	$ 12,319.40		
Less: Allowance for Doubtful		1,390.10	10,929.30	
Accounts Receivable:				
Customers—Domestic	$244,083.98			
Foreign Drafts Drawn	25,390.25	$ 269,474.23		
Less: Allowance for Doubtful and Discounts		16,000.00		
		$ 253,474.23		
Trade Creditors' Debit Balances		2,211.00	255,685.23	
Merchandise Inventories:				
Raw Materials on Hand	$194,322.39			
Raw Materials in Transit	26,610.60			
Work in Process	124,013.30			
Finished Goods	751,164.23			
Goods on Consignment	19,050.00			
Manufacturing Supplies	59,440.87			
Waste	3,161.75	1,177,763.14		
Advances on Raw Materials		18,470.41	1,196,233.55	
(Merchandise of a cost value of $24,392.40 was covered by Trust Receipts issued in connection with Drafts Against Letters of Credit of a like amount).				
Cash Surrender Value—Life Insurance		$ 10,701.63		
Less: Loan and Accrued Interest		4,642.86	6,058.77	$1,748,364.71
Other Assets:				
Investments in Outside Real Estate			$ 35,342.55	
Accounts Receivable—Warren Mfg. Co.			21,120.30	
Notes and Accounts Receivable—Officers and Employees			7,618.25	
Miscellaneous Stock and Claims			621.50	
Mortgages Receivable			3,012.25	
Customer's Note Receivable due subsequent to December 31, 1929			1,793.75	69,508.60
Permanent:				
Land, Buildings, Machinery, Equipment, etc.			$2,641,954.53	
Less: Allowance for Depreciation			985,745.68	1,656,208.85
Patents (Less Amortization)				15,894.80
Goodwill				100,000.00
Deferred Charges				111,362.65
				$3,701,339.61

Sheet
Company, Boston, Massachusetts
31, 1928
9

Liabilities

Current:					
Notes Payable:					
For Borrowed Money					
Banks		$50,000.00			
Brokers		25,000.00			
Officer		15,000.00	$ 90,000.00		
For Machinery			2,582.25	$ 92,582.25	
Drafts Against Letters of Credit (Covered by Trust Receipts, See Contra)				24,392.40	
Trade Acceptances Payable				84,835.50	
Accounts Payable:					
Trade Creditors			$ 150,569.74		
Officers and Employees			8,831.12		
Unclaimed Wages			1,197.30		
Customers' Credit Balances			401.48	160,999.64	
Dividend Payable:					
Common Stock—Payable January 15, 1929				20,000.00	
Accrued Accounts:					
Salaries and Wages			$ 21,097.64		
Interest			13,654.15		
Commissions			8,350.00		
Expenses			1,863.83	44,965.62	
Federal and State Income Taxes—Estimated				33,850.60	$ 461.626.01
Deferred Liability:					
Note Payable—For Machinery					2,582.25
Deferred Income:					
Prepaid Interest—Notes Receivable					136.50
Bonded Indebtedness:					
First Mortgage 5 % Gold Bonds due Aug. 1, 1937				$ 630,000.00	
Less: In Treasury				4,000.00	626,000.00
Capital:					
Capital Stock					
7 % Cumulative Preferred—Authorized and Issued			$ 500,000.00		
Common—Authorized		$1,500,000.00			
Less: Unissued	$450,000.00				
In Treasury	50,000.00	500,000.00	1,000,000.00	$1,500,000.00	
Surplus				1,110,994.85	2,610,994.85
					$3,701,339.61

No Contingent Liabilities Reported

Note: This Balance Sheet is subject to the comments contained in the letter attached to and made a part of this report.

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INCOME AND EXPENSE
CHARLES DARNER MANUFACTURING COMPANY,
BOSTON, MASSACHUSETTS
FOR THE YEAR ENDED DECEMBER 31, 1928

INCOME				
Gross Sales				$2,559,773.88
Less: Returns and Allowances			$ 73,170.82	
Discounts Allowed			26,130.76	99,301.58
Net sales				$2,460,472.30
				100 %
Cost of Goods Sold				
Inventory, Jan. 1, 1928			$1,225,691.60	
Purchases	$1,289,198.80			
Freight Inward	41,239.32	$1,330,438.12		
Less: Discounts Earned		17,395.43	1,313,042.69	
Direct Labor			227,870.54	
Manufacturing Expenses				
Depreciation		$ 98,988.04		
Light, Heat and Power		51,417.88		
Indirect Labor		44,363.86		
Manufacturing Supplies		40,870.71		
Local Taxes		19,280.26		
Auto and Trucking Expenses		12,543.32		
Repairs		11,762.24		
Electrical Supplies and Expenses		9,636.35		
Miscellaneous		9,323.96		
Insurance		7,435.83		
Amortization of Patents		2,755.88	308,378.33	
			$3,074,983.16	
Less: Inventory, December 31, 1928		$1,177,763.14		75.62 %
Sales of Waste		36,673.93	1,214,437.07	1,860,546.09
Gross Profit				$ 599,926.21
				24.38 %
EXPENSES				
General Administrative and Selling				
Commissions			$ 92,566.88	
Officers' Salaries			90,000.00	
Office Salaries			37,725.34	
Salesmen's Salaries			15,263.34	
Freight and Cartage Out			12,970.21	
Miscellaneous			10,661.73	
Professional Services			9,935.00	
Traveling			6,761.30	
Depreciation—Furniture and Fixtures			5,477.56	
Dues and Subscriptions			4,767.34	
Selling Supplies and Expenses			4,303.16	
Credit and Collection			4,111.46	
Advertising			3,643.21	
Telephone, Telegraph and Postage			2,283.90	12.24 %
Office Supplies and Expenses			470.00	300,940.43
Net Profit from Operations				$ 298,985.78
				12.14 %
Other Income				
Net income from Outside Property			$ 4,105.25	
Income from Marketable Securities			3,582.50	
Unclaimed Wages			1,430.96	
Miscellaneous			1,393.61	$10,512.32
Deductions from Income				
Interest Paid		$45,895.68		
Less: Interest Earned		5,867.40	$40,028.28	
Organization Expense Amortized			20,750.00	
Forward				$ 298,985.78

Page 10 (*Continued*)
INCOME AND EXPENSE (*Continued*)
CHARLES DARNER MANUFACTURING COMPANY,
BOSTON, MASSACHUSETTS
FOR THE YEAR ENDED DECEMBER 31, 1928

Brought Forward				$298,985.78
Amortization of Bond Discount		17,586.10		
Bad Debts Written Off	$11,184.98			
Less: Bad Debts Recovered	897.44	10,287.54		
Adjusting Securities to Market		4,686.50		
Officers' Life Insurance Premiums—Net		3,110.67		
State Taxes		2,808.06		
Loss on Sale of Capital Assets		403.60	99,660.75	89,148.43
Net Profit Before Federal and State Taxes				$209,837.35
Provision for Federal and State Income Taxes				33,850.60
Net Profit Carried to Surplus				$175,986.75

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ANALYSIS OF SURPLUS
CHARLES DARNER MANUFACTURING COMPANY,
BOSTON, MASSACHUSETTS
FOR THE YEAR ENDED DECEMBER 31, 1928

Surplus per Report December 31, 1927				$1,072,499.70
Addition				
Net Profit per statement of Income and Expense			$175,986.75	
Deductions				
Dividends Paid and Declared				
Preferred	$ 35,000.00			
Common	100,000.00	$135,000.00		
Additional assessment—1926 Federal Income Taxes		2,491.60	137,491.60	38,495.15
Surplus per Balance Sheet December 31, 1928				$1,110,994.85

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Reconciliation of Surplus
Charles Darner Manufacturing Company, Boston, Massachusetts
December 31, 1928

Surplus per Company				$1,211,210.65
Additions				
Adjusting the following Assets and Expenses:				
Depreciation written off	$ 2,858.25			
Patent amortization	1,185.30			
Cash Value—Life Insurance	864.63			
Cash for interest, bank charges, etc.	469.20	$ 5,377.38		
Providing for the following Prepaid and Accrued Interest:				
Notes Payable—Prepaid Interest	$ 1,584.86			
Marketable Securities—Acc. "	716.10			
Certificates of Deposit " "	375.00			
Mortgages Receivable " "	12.25	2,688.21	$ 8,065.59	
Deductions				
Providing for the following Accrued Expenses and Liabilities:				
Federal and State Income Taxes	$33,850.60			
Common Dividend	20,000.00			
Unentered Purchase Invoices	6,353.10			
" Expense "	3,184.25			
Commissions	2,237.55			
Water	1,680.23			
Interest—Notes Payable	612.50			
Expenses	183.16			
Traveling	142.82			
Interest—Life Insurance Loan	105.86	$68,350.07		
Providing for the following:				
Amortization of Bond Discount	$17,586.10			
Allowance for Doubtful Notes	1,390.10			
Additional Allowance for Doubtful Accounts	1,000.00			
Depreciation on Outside Real Estate	457.45			
Loss on Sale of Capital Assets	403.60	20,837.25		
Adjusting the following items:				
Consigned Goods to cost	$ 6,350.00			
Inventories for errors in prices and computations	5,351.76			
Securities to Market	4,686.50			
Accrued Interest on Bonds	1,166.65			
Prepaid and Accrued Insurance	746.29			
Prepaid Taxes	441.38			
Expense charged to patents	300.00			
Accrued Interest—Notes Receivable	25.75			
Prepaid Wages	25.74	19,094.07	108,281.39	100,215.80
Surplus per Balance Sheet				$1,110,994.85

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Cash
Charles Darner Manufacturing Company, Boston, Massachusetts
December 31, 1928

On Deposit:			
Third National Bank, Boston, Mass.		$75,555.63	
Commonwealth National Bank, Boston, Mass.		49,632.77	
Bay State Trust Company, Boston, Mass.		15,432.60	$140,621.00
Certificates of Deposit:			
Third National Bank, Boston, Mass.	$30,000.00		
Commonwealth National Bank, Boston, Mass.	20,000.00	50,000.00	
Accrued Interest		375.00	50,375.00
			190,996.00*
In Transit:			
Third National Bank, Boston, Mass.			10,225.60
On Hand:			
Boston, Massachusetts			707.66
			$201,929.26

* Green.

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Marketable Securities
Charles Darner Manufacturing Company, Boston, Massachusetts
December 31, 1928

Par Value or Number of Shares	Securities	Book Value	Cost	Market Value	Lower of Cost or Market Value
	Bonds				
10,000	Atchison Topeka & Santa Fe R Y. Co. 4½–48	$ 9,800.00	$ 9,800.00	$ 14,700.00	$ 9,800.00
10,000	Chesapeake Corp. 5–47	9,800.00	10,000.00	9,700.00	9,700.00
15,000	Detroit Edison Co. 5–62	14,550.00	14,550.00	14,600.00	14,550.00
7,000	N. Y. Edison Co. 6–41	6,900.00	6,900.00	7,300.00	6,900.00
25,000	U. S. Liberty Loan 4th 4¼–38	24,937.50	25,000.00	24,812.50	24,812.50
		65,987.50*	66,250.00*	71,112.50*	65,762.50*
	Stocks				
50 shs.	Baltimore and Ohio R.R. Co.—Com.	4,250.00	4,800.00	6,000.00	4,800.00
50 "	U. S. Steel Corporation	6,012.50	6,250.00	9,000.00	6,250.00
		10,262.50*	11,050.00*	15,000.00*	11,050.00*
		$76,250.00	$77,300.00	$86,112.50	$76,812.50
	Add: Accrued Interest				716.10
					$77,528.60

* Green.

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NOTES AND TRADE ACCEPTANCES RECEIVABLE
CHARLES DARNER MANUFACTURING COMPANY,
BOSTON, MASSACHUSETTS
DECEMBER 31, 1928

Date	Maker	Due Date	Interest Rate	Amount	
	Notes				
10/1/28	Black Mfg. Co., Boston, Mass.	1/31/29	5%	....	$ 490.10
8/31/28	Collins, J. J., Boston,	11/30/28	6	$ 600.00	
" " "	Mass.	12/31/28	6	600.00	
" " "	....	1/31/29	6	600.00	1,800.00
10/31/28	Warren and Sampson Boston, Mass.	6/30/29	6	....	4,550.00
10/1/28	Young, F. S., Boston, Mass.	4/1/29	6	....	2,800.00
					9,640.10*
	Trade Acceptances				
12/1/28	Pratt Co., E. E., Boston,	1/1/29	none	$1,211.82	
" " "	Mass.	2/1/29	"	1,425.48	2,637.30
					2,637.30*
					$12,277.40
	Add: Accrued Interest	....	....	....	42.00
					$12,319.40
	Deduct: Allowance for Doubtful	....	....	....	1,390.10
					$10,929.30

* Green.

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ACCOUNTS RECEIVABLE—CURRENT
CHARLES DARNER MANUFACTURING COMPANY,
BOSTON, MASSACHUSETTS
DECEMBER 31, 1928

Customers—Domestic	
Adams Co., T. W.	$ 25,983.76
Darrow, Benjamin	16,436.05
Gwinn & Co., C. B.	15,102.06
Karl, Pace & Co.	12,102.56
Mersey, Harris & Co.	33,624.90
Waitt, O. A.	2,361.25
Wright, A. A.	3,910.55
Yost, O. O.	1,822.22
189 Accounts less than $1,000.00 each aggregating	132,740.63
	$244,083.98*
Foreign Drafts Drawn	25,390.25
	$269,474.23
Less: Allowance for Doubtful and Discounts	16,000.00
	$253,474.23
Trade Creditors' Debit Balances	2,211.00
	$255,685.23

* Green.

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MERCHANDISE INVENTORIES
CHARLES DARNER MANUFACTURING COMPANY,
BOSTON, MASSACHUSETTS
DECEMBER 31, 1927 AND DECEMBER 31, 1928

Accounts	December 31, 1928	December 31, 1927	Increase Decrease*
Raw Materials on Hand	$ 194,322.39	$ 192,806.53	$ 1,515.86
Raw Materials in Transit	26,610.60	....	26,610.60
Work in Process	124,013.30	162,370.60	38,357.30*
Finished Goods	751,164.23	813,099.95	61,935.72*
Manufacturing Supplies	59,440.87	52,607.80	6,833.07
Waste	3,161.75	4,806.72	1,644.97*
Goods on Consignment	19,050.00	....	19,050.00
	1,177,763.14†	1,225,691.60†	47,928.46†
Advances on Raw Materials	18,470.41	....	18,470.41
	$1,196,233.55	$1,225,691.60	$29,458.05*

* Red.
† Green.

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LIFE INSURANCE
CHARLES DARNER MANUFACTURING COMPANY,
BOSTON, MASSACHUSETTS
DECEMBER 31, 1928

Insured	Coverage	Cash Surrender Value	Loans and Accrued Interest	Net Cash Surrender Value
Charles Darner, President				
New York Life Ins. Co.	$ 5,000.00	$ 2,243.25	....	$2,243.25
" " " " "	5,000.00	2,137.78	....	2,137.78
Equitable Life Ass. Soc.	15,000.00	830.55	....	830.55
" " " "	50,000.00	....	....	....
	75,000.00*	5,211.58*	....	5,211.58*
R. M. Darner, Vice President				
Federal Mutual Ins. Co.	25,000.00	3,900.82	$3,316.62	584.20
" " " "	10,000.00	1,589.23	1,326.24	262.99
" " " "	10,000.00	....	....	....
	45,000.00*	5,490.05*	4,642.86*	847.19*
Peter Cranston, Treasurer		....	....	....
Connecticut General Life	20,000.00	....	....	....
" " "	10,000.00	....	....	....
Aetna Life Ins. Co.	5,000.00	....	....	....
	35,000.00*	....	....	....
	$155,000.00	$10,701.63	$4,642.86	$6,058.77

* Green.

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OTHER ASSETS
CHARLES DARNER MANUFACTURING COMPANY,
BOSTON, MASSACHUSETTS
DECEMBER 31, 1928

Investments in Outside Real Estate:		
Land and Buildings	$35,800.00	
Less: Allowance for Depreciation	457.45	$35,342.55
Account Receivable:		
Warren Mfg. Co., Boston, Mass.		21,120.30
Miscellaneous Notes, Accounts, Etc.:		
Accounts Receivable—Officers and Employees:		
Austin, C. A.	$ 25.00	
Brown, B.	125.00	
Downs, L. C.	925.50	
Goodhue, R.	1,750.00	
Macomber, R. H.	9.62	
Sampson, L. G.	1,194.13	
Small, L. B.	24.00	
Thomas, H.	40.00	
Walsh, F. G.	1,250.00	
Zero, R. C.	750.00	
	6,093.25*	
Notes Receivable—Officer:		
Jones, Robert Due 9/1/29	1,525.00	
Transportation Claim:		
Western Maryland Railway	620.50	
Miscellaneous Investment:		
525 shares West Newton Knitting Mills Common Stock	1.00	8,239.75
Mortgages Receivable:		
Herbert B. and Maud I. Burrell 10 Pearl St., Malden, Mass.		3,012.25
Customer's Note Receivable due Subsequent to Dec. 31, 1929:		
French Co., O. A. Due 1/1/30		1,793.75
		$69,508.60

* Green.

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Permanent Assets
Charles Darner Manufacturing Company, Boston, Massachusetts
For the year ended December 31, 1928

Assets

	Balance Jan. 1, 1928	Additions	Deductions	Balance Dec. 31, 1928
Land	$ 99,510.00	....	....	$ 99,510.00
Buildings	1,041,762.86	$10,033.84	....	1,051,796.70
Machinery and Equipment	1,396,687.76	10,825.64	$3,087.80	1,404,425.60
Automobiles and Trucks	9,846.12	3,068.18	611.87	12,302.43
Office Furniture and Fixtures	73,370.80	799.00	250.00	73,919.80
	$2,621,177.54	$24,726.66	$3,949.67	$2,641,954.53

Allowance for Depreciation

	Balance Jan. 1, 1928	Additions	Deductions	Balance Dec. 31, 1928	Net Depreciated Book Value
Land	....	....	....	....	$ 99,510.00
Buildings	$460,049.01	$ 20,835.26	....	$480,884.27	570,912.43
Machinery and Equipment	393,655.85	75,589.03	$2,441.40	466,803.48	937,622.12
Automobiles and Trucks	4,050.20	2,563.75	611.87	6,002.08	6,300.35
Office Furniture and Fixtures	26,778.29	5,477.56	200.00	32,055.85	41,863.95
	$884,533.35	$104,465.60	$3,253.27	$985,745.68	$1,656,208.85

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Deferred Charges
Charles Darner Manufacturing Company, Boston, Massachusetts
December 31, 1928

Bond Discount Unamortized	$ 43,871.08
Organization Expense	41,500.00
Prepaid Taxes	13,673.82
Operating Supplies	7,162.70
Unexpired Insurance Premiums	3,210.93
Prepaid Interest	1,584.86
Prepaid Wages	284.26
Prepaid Expenses	75.00
	$111,362.65

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NOTES PAYABLE
CHARLES DARNER MANUFACTURING COMPANY,
BOSTON, MASSACHUSETTS
DECEMBER 31, 1928

Date of Note	Payable To	Due Date	Amount	
Current:				
	For Borrowed Money			
	Banks			
11/15/28	Third National Bank of Boston	1/5/29	$5,000.00	
11/10/28	" " Boston, Mass.	1/10/29	5,000.00	
11/20/28	" " " "	1/20/29	5,000.00	
12/9/28	" " " "	2/9/29	5,000.00	
12/20/28	" " " "	2/10/29	5,000.00	$25,000.00
10/20/28	Commonwealth National Bank, Boston, Mass.	1/20/29		25,000.00
	Brokers			
11/16/28	Donahue Bros., Boston, Mass.	1/15/29	5,000.00	
" " "	" " " "	"	5,000.00	
" " "	" " " "	"	5,000.00	
" " "	" " " "	"	5,000.00	
" " "	" " " "	"	5,000.00	25,000.00
	Officer			
4/30/28	Charles Darner, President, Boston, Mass.	Demand		15,000.00
				90,000.00*
	For Machinery			
11/17/28	Franklin Process Co., Boston, Mass.	5/17/29		2,582.25
				2,582.25*
				$92,582.25
Deferred:				
	For Machinery			
11/17/28	Franklin Process Co., Boston, Mass.	5/17/30		$ 2,582.25

* Green.

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Drafts against Letters of Credit
Charles Darner Manufacturing Company,
Boston, Massachusetts
December 31, 1928

Bankers	Due Date	Amount
Brown Brothers & Co., Boston, Mass.	3/12/29	$13,347.80
Kidder, Peabody & Co., " "	1/6/29	4,742.40
Third National Bank, " "	2/6/29	1,960.00
Webster and Atlas National Bank, Boston, Mass.	1/17/29	4,342.20
		$24,392.40

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Trade Acceptances Payable
Charles Darner Manufacturing Company,
Boston, Massachusetts
December 31, 1928

Date	Payee	Due Date	Amount	
12/31/28	Atlas Yarn Co., New Bedford, Mass.	3/31/29		$ 6,353.10
11/30/28	Abbot Yarn Co., Lawrence, "	2/28/29		29,696.31
12/15/28	New England Mfg. Co., Fall River, Mass.	3/15/29	$10,309.60	
12/27/28	" " " " " " "	3/27/29	33,249.70	
12/30/28	" " " " " " "	3/31/29	5,226.79	48,786.09
				$84,835.50

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BAD DEBTS WRITTEN OFF AND RECOVERED
CHARLES DARNER MANUFACTURING COMPANY,
BOSTON, MASSACHUSETTS
FOR THE YEAR ENDED DECEMBER 31, 1928

Bad Debts Written Off:		
Adams, H. M. Co.	$ 491.11	
American Mfg. Co.	406.33	
Bradley Bros., Inc.	1,505.55	
Briggs, Ralph and Sons Co.	1,463.20	
Donald and Pratt, Inc.	542.80	
Goodwear Mfg. Co.	972.67	
Hope Mfg. Co.	1,872.32	
Howard and Co., Inc.	1,540.90	
	8,794.88*	
Additions to Allowance For Doubtful Accounts	2,390.10	$11,184.98
Less: Bad Debts Recovered:		
Alberta Mills, Inc.	$ 109.42	
Flint and Co.	78.82	
Goodnow and Co., Inc.	96.70	
Hadley Mills	112.50	
Webster, F. W. Co.	500.00	897.44
		$10,287.54

* Green.

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INSURANCE COVERAGE
CHARLES DARNER MANUFACTURING COMPANY,
BOSTON, MASSACHUSETTS
DECEMBER 31, 1928

Kind of Insurance	*Amount*
Fire—Buildings and Contents	$2,100,000.00
Credit Insurance	50,000.00
Paymaster Robbery	15,000.00
Automobile—Public Liability, Blanket Policy	500/1,000,000.00
" Property Damage	1,000.00
" Fire and Theft	6,000.00
Workmen's Compensation	

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RANGE OF INDEBTEDNESS
CHARLES DARNER MANUFACTURING COMPANY,
BOSTON, MASSACHUSETTS
FOR THE YEAR ENDED DECEMBER 31, 1928

Month	Notes Payable	Drafts and Trade Acceptances Payable	Accounts Payable and Accrued Accounts	Total
December 1927......	$ 150,000.00	$ 50,000.00	$ 121,537.65	$ 321,537.65
January 1928......	200,000.00	85,000.00	197,322.23	482,322.23
February "	250,000.00	110,000.00	250,285.15	610,285.15
March "	300,000.00	110,000.00	245,868.23	655,868.23
April "	200,000.00	135,000.00	274,654.86	609,654.86
May "	250,000.00	100,000.00	255,559.73	605,559.73
June "	250,000.00	150,000.00	244,270.59	644,270.59
July "	250,000.00	200,000.00	269,952.64	719,952.64
August "	250,000.00	150,000.00	251,517.90	651,517.90
September "	200,000.00	150,000.00	277,640.42	627,640.42
October "	200,000.00	100,000.00	263,457.97	563,457.97
November "	200,000.00	50,000.00	249,886.90	499,886.90
December "	95,164.50	109,227.90	205,965.26	410,357.66
Total for 13 Months...	$2,795,164.50	$1,499,227.90	$3,107,919.53	$7,402,311.93
Average............	$ 215,012.66	$ 115,325.22	$ 239,070.73	$ 569,408.61

NOTE: This statement was prepared from the Company's books without audit or adjustment by us.

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